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# ASSESSING RECENTLY REVEALED PROBLEMS IN FHA AND GINNIE MAE

## HEARINGS

BEFORE THE

SUBCOMMITTEE ON
HOUSING AND URBAN AFFAIRS

OF THE

## COMMITTEE ON
## BANKING, HOUSING, AND URBAN AFFAIRS
## UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

THE GROWING EVIDENCE THAT FHA RESERVES HAVE BEEN WEAKENED BY MISMANAGEMENT, FRAUD, ABUSE, AND BY THE ECONOMIC SLUMP IN THE SOUTHWEST

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AUGUST 1 AND 3, 1989

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# ASSESSING RECENTLY REVEALED PROBLEMS IN FHA AND GINNIE MAE

TUESDAY, AUGUST 1, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS,
*Washington, DC.*

The subcommittee met at 10:25 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Alan Cranston (chairman of the subcommittee) presiding.

Present: Senators Cranston, D'Amato, and Pressler.

## OPENING STATEMENT OF SENATOR CRANSTON

Senator CRANSTON. We now proceed with the Subcommittee on Housing and Urban Affairs hearing to assess problems in FHA and Ginnie Mae, to determine the legislative remedies.

Our witnesses are Charles A. Bowsher, Comptroller General of the United States; and Thomas J. Craren, a Partner in Price-Waterhouse, Office of Government Services.

We welcome you.

I have an opening statement to make. I thank all of you for your presence.

This morning's hearing, the Senate Housing Subcommittee begins a major review of the management and financial soundness of the Federal Housing Administration.

For half a century, the FHA has been the premier national housing institution. FHA has helped over 17 million American families become homebuyers and has provided favorable financing terms for over 4 million units of affordable rental housing.

FHA created the modern long-term, evenly amortizing mortgage. FHA has taken the lead in making home mortgages into safe and standardized loans.

And FHA has improved the quality of housing construction by developing building requirements that set a standard for the industry.

Because I support the FHA, I am deeply disturbed by growing evidence that FHA reserves have been weakened in recent years by mismanagement, by fraud and abuse, and by the continuing economic slump in the southwest.

The hearings we now start will seek a full and objective assessment of the problems at FHA. The hearings will continue Thursday with testimony from C. Austin Fitts, who was just with us, who

I trust will by that time, will be the Assistant Secretary for Housing.

Subsequent hearings will continue in September and will consider the financial viability of Ginnie Mae as well.

This series of hearings is distinct from the Banking Committee's investigation of misconduct in HUD's Moderate Rehab Program. That full committee investigation will consider mismanagement and abuse related to the Mod Rehab and related programs between the years 1978 and 1988.

This series of subcommittee hearings will consider the future soundness of Federal support for home mortgage finance.

We will pursue any legislative remedies that may be necessary to make FHA a strong and responsive institution that is able to serve the housing needs of future generations in all parts of this country as magnificently as it has served the needs of the American people years ago. I will be satisfied with nothing less, I assure all concerned.

The foundation of effective legislative action is already pending before this committee.

Two and a half years ago, this subcommittee began a nationwide effort to develop a major new housing bill. All of us who participated in this effort, including a large number of the country's housing leaders, knew the effort had to be ambitious. We did not know of the misdeeds of individuals, of course, when this process began.

But we knew that, during the Reagan years, HUD was badly weakened, badly demoralized and in need of thoroughgoing reform.

For that reason, the Cranston-D'Amato National Affordable Housing Act emerged as comprehensive reform legislation that would make a sweeping overhaul of HUD and Federal housing programs.

Now, the entire country is learning the extent of the Reagan Administration's mismanagement and abuse of HUD. The unfolding scandal shows the extent to which the country's housing policy has been in the hands of its enemies.

The scandal reveals the cynicism and hypocrisy of those who were trying to destroy Federal support for housing. We must not let their corruption now be used as an excuse to complete their mission.

Work on the Cranston-D'Amato bill gives us an enormous head start in enacting landmark legislation to clean up the mess that's been left at HUD and to revitalize Federal support for affordable housing.

I want to make it clear:

When our bill is enacted, it will be the reform legislation that restructures HUD for the future.

The subcommittee is now refining the bill and expanding the bill's scope and the strengthening of FHA is a major concern.

The opponents of housing have kept FHA under constant, hostile pressure for the past 8 years. An early Reagan Administration goal was to phase out the FHA within 4 years. Later, they floated a plan to sell off FHA.

Administration blockage of legislation caused FHA to shut down 7 times in 2 years, for a total of 52 days, when demand for home mortgage finance was at record levels.

FHA staff was slashed by about one-third. Many of the best people were driven out; and a hiring freeze kept out new talent. Those who remained were often transferred into sensitive jobs for which they had little experience.

The key position of Assistant Secretary for Housing/FHA Commissioner, as I noted earlier, became a musical chair filled by 7 different people in 8 years.

Incredibly poor management and sloppy procedures permitted criminal activities to go undetected for long periods of time. Large checks were left lying around in drawers. One fiscal agent alone was able to misappropriate $5.5 million from the proceeds of HUD property sales.

Major new initiatives, such as an expansion of coinsurance, were undertaken with completely inadequate provision for oversight and monitoring. The resulting fraud created enormous cost to the taxpayers. The actions of one lender alone are expected to cost the FHA fund $300 million.

The facts are shocking and more may yet come to light.

Nevertheless, I know that there have been many examples of heroic efforts by dedicated FHA employees who struggled against enormous odds to do their jobs well. That effort deserves recognition and appreciation.

I suspect that the problems at FHA are not merely the result of misdeeds by some individuals. It is most likely the problems result from deeper, systemic weaknesses that have resulted from the fact that the structure and operations of FHA have not been adequately modernized and monitored.

As long ago as October 1977, the Senate Banking Committee held hearings on the "Future of FHA", in which it became clear that the FHA would have to adapt to profound changes in the housing market.

It was recognized then that FHA's traditional methods and technologies could not serve the new needs. The required reforms were not made in the past decade, so now the need for reform is even more intense.

The National Affordable Housing Act must address these problems if the bill is to achieve its objectives. The bill is in the process of development still. We are strengthening it with suggestions that have already emerged in hearings.

I intend to get Senate action on that legislation this year. And I intend to make sure that the bill will provide the FHA a strong foundation on which we can build new national housing policy.

These hearings will provide a new and objective assessment of FHA's condition. We will not stop until we have remedies for FHA's problems.

I welcome the communications that I've received from Secretary Kemp endorsing our efforts on this particular hearing.

We will probe the full extent of the problems at FHA. We need to understand the amounts of money involved and the nature of any management failures. We will explore the degree to which these problems could affect the long-term integrity of the FHA fund.

We need to determine what must be done to stem the losses and to guarantee that FHA remain sound for the long-term.

Our witnesses today are uniquely well-qualified to help us come to grips with these important questions.

The General Accounting Office has long been a major center of analysis of FHA's operations and financial condition.

And during the past few years, GAO has contracted with Price-Waterhouse to conduct a full financial audit of FHA, the first in many years.

A massive effort to construct a reliable set of financial statements will reveal much information that will be vital to the working of this Subcommittee.

I look forward to receiving your testimony. We will start with that of Charles Bowsher, Comptroller General of the United States.

We welcome you.

Al D'Amato first has an opening statement.

## OPENING COMMENTS OF SENATOR D'AMATO

Senator D'AMATO. Yes, Mr. Chairman. I have a lengthy opening statement that I'm going to ask be placed in the record as if read in its entirety.

However, Mr. Chairman, let me just relate to you one paragraph of that statement because I think it's important:

It is critical that alterations to the FHA program take into consideration the findings of the recent GAO financial audit of the FHA fund. This audit, conducted by Price-Waterhouse, was issued in May 1989 and it brings to our attention important issues relating to the long-term viability of the FHA fund.

The audit reiterates the need for this Subcommittee to further assess the FHA reform provisions contained in S. 565. At the conclusion, addressing remarks to C. Austin Fitts, I intend to explore with her some of the provisions that we put forth.

While I recognize that there are indeed very legitimate areas of disagreement in S. 565, I also am looking forward to not only addressing what we would do and what we suggested, but what the Comptroller General and Price-Waterhouse think is necessary to ensure the stability of the fund.

What else should we be doing to see that there are proper safeguards, so that we don't find ourselves in the not too distant future facing a horrendous situation similar to the S&L crisis?

And I have to say that I fear a good deal of concern as a result of some of the recent disclosures in terms of the mismanagement and in terms of the losses that have already been incurred and the potential for greater losses to follow.

So I am certainly looking forward, Mr. Comptroller General, to not only what you found but what suggestions you'd be able to make about seeing to it that there are minimum safeguards that are undertaken, that may not be in place at this time.

Thank you, Mr. Chairman.

[The complete prepared statement of Senator D'Amato follows:]

## STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, I am pleased to join you today in response to a series of reports and articles which bring into question the viability of the FHA insurance fund. This hearing will

attempt to get a clearer understanding of the financial state of the Federal Housing Administration (FHA) fund and to determine the need for legislative remedies.

The recent report submitted by the GAO and the articles printed in the Wall Street Journal and New York Times surface at a critical time. The Senate and the administration are assessing proposals to reform the FHA mortgage insurance program. In particular, the legislation that Senator Cranston and I have been developing for 2 years, S. 565, contains a number of provisions which alter FHA to assist first-time homebuyers.

Specifically, the National Affordable Housing Act would:

One, lower the downpayment required for an FHA mortgage to 3 percent of the first $50,000 and 5 percent for the additional amount, and to 3 percent for homebuyers who participate in a qualified housing counseling program,

Two, increase FHA mortgage limits to 95 percent of the median sales price for the State, and

Three, allow FHA to insure ARMs [Adjustable Rate Mortgages] under which interest rates may rise 2 percent a year and no more than 5 percent over the life of the mortgage.

It is critical that alterations to the FHA program take into consideration the findings of the recent GAO financial audit of the FHA fund. This audit, conducted by Price Waterhouse, was issued in May of 1989. It brings to our attention important issues relating to the long-term viability of the FHA fund. The audit reiterates the need for this Subcommittee to further assess the FHA reform provisions contained in S. 565.

In addition to the GAO study, recent articles in the New York Times and Wall Street Journal have expressed a number of concerns about FHA reform. While I disagree with a number of the assertions of these articles, I certainly agree that we must take a serious look at the financial state of the fund and that we should be sure that all provisions in the National Affordable Housing Act promote the continued stability of the fund. If in this hearing process we discover that any of the homeownership provisions in S. 565 jeopardize the long-term future of the fund, this subcommittee will need to make the appropriate revisions to the legislation.

## FHA PROGRAM

As we begin to assess FHA, it is important to look at what has happened to the fund over the last few years. Two years ago, when Senator Cranston and I began the process of developing S. 565, the FHA fund data appeared to be stable and solvent. FHA was operating in the black, serving as one of the few Federal programs which generated revenues for the Federal Government. The National Housing Task Force Report [Rouse-Maxwell report] reflected this "trouble free" feeling about FHA by recommending that the FHA insurance program be expanded to help firsttime homebuyers purchase a home.

However, the increasing premiums and steady levels of claims shifted in 1987. At that time, the Mutual Mortgage Insurance Fund [MMI], FHA's largest insurance program, began to experience a net outflow of cash.

Statistics which describe the fund since 1987 are disturbing. Last year the fund lost $452 million. To help meet its fiscal year 1988 cash needs, FHA had to redeem $643 million of U.S. Treasury securities ahead of the planned maturity schedule. In addition, the fund has experienced—and continues to experience—a rising rate of mortgage delinquency—from 2 percent in 1979 to 5.5 percent at the end of 1988. Third, the fund has $1.2 billion in equity at the end of 1987 to support $277 billion of insurance-in-force. These statistics raise questions about the current state of the fund and the long term viability of the fund.

There are a variety of factors which seem to explain why FHA is, for the first time in recent history, experiencing a net outflow of cash. Because of declining rates of homeownership around the nation, FHA is experiencing a decline in premium collections. Simultaneously, the fund is experiencing an increase in claim payments. This could be because the high levels of insurance written in 1986 and 1987 are now entering their historically high claim period. These claims will gradually level off over time and do not have a significant long-term effect on the fund, but may create short term cash flow problems. In addition, as with most Federal insurance funds, the FHA has incurred significant losses in economically distressed areas, most notably, Texas, Oklahoma, Colorado, and Louisiana.

Although these factors help explain why the fund is experiencing losses, we do not know the exact reasons for the turnaround with the FHA fund. There has been a lot of discussion about problems with the coinsurance program, and it is unclear what kind of role these problems may have played with the recent FHA losses.

In spite of these trends, the GAO study indicates that as of December 31, 1987, the FHA's largest insurance program—the Mutual Mortgage Insurance Fund—was in a strong financial position relative to future performance under probable future economic conditions. However, the report cautions that the MMI Fund would have difficulty surviving under more severe regional stress, and would not survive under conditions of national stress without U.S. Treasury support.

## GINNIE MAE

Ginnie Mae [Government National Mortgage Association] guarantees the timely payment of principal and interest on securities issued by private lenders and backed by pools of FHA-insured mortgages. Ginnie Mae has proven to be a beneficial piece of the housing finance system. Because of the direct link between FHA and Ginnie Mae, this hearing will also look at the impact FHA losses have on current and future Ginnie Mae operations.

As a key advocate for assisting first-time homebuyers, I want to ensure that S. 565 promotes long-term homeownership options for working families of this nation. I look forward to working with Senator Cranston and many of you in this room today to achieve this goal.

Thank you, Mr. Chairman.

Senator CRANSTON. Thank you very much.

Now, if you would proceed, Mr. Bowsher, we welcome your views.

**STATEMENT OF CHARLES A. BOWSHER, COMPTROLLER GENERAL OF THE UNITED STATES, GENERAL ACCOUNTING OFFICE, WASHINGTON, DC, ACCOMPANIED BY THOMAS J. CRAREN, PARTNER, PRICE WATERHOUSE, OFFICE OF GOVERNMENT SERVICES, WASHINGTON, DC, AND BRIAN P. CROWLEY; JOHN M. OLS, JR., DIRECTOR, HOUSING AND COMMUNITY DEVELOPMENT ISSUES**

Mr. BOWSHER. Thank you very much, Mr. Chairman, Senator D'Amato. I have a 16-page statement that I would like to have inserted in the record, if I could. And I'll summarize our positions here.

I think that the main problem that we've had the last number of years at HUD is that we've not been able to do an audit of the accounting records because of problems with the accounting systems and controls.

These accounting systems and controls started deteriorating in the seventies and since then we have just not been able to do our regular audits.

I do say that some of the people at HUD in the mid-1980's started to take our concerns and criticisms to heart and started a program of trying to improve the accounting systems and the controls.

So, in 1987, we tried to do an audit. We hired Price Waterhouse, as you pointed out, and we were able to do what's known as a balance sheet audit.

Now, why do a balance sheet audit the first year that you can get back in to start auditing?

You do it because you've got to establish an opening balance of what the assets really amount to, you might say.

Then, in 1988, we concluded, in consultation with Price Waterhouse that a full audit was possible. That audit is ongoing at this time.

We hope to be able to report to everyone, in September, the results of that audit and to have a complete written report sometime shortly thereafter.

So, today, we can talk about what we have as the result of the 1987 audit and our plans on the 1988 audit.

ANNUAL AUDIT

I'd like to point out that I believe one of the things we have to have in the future is an annual audit. I think that we made a mistake back in the mid-1970's when we decided to go away from annual audits to an audit every 3 years. And then, as the accounting systems deteriorated, of course, we weren't able to audit at all for a number of years.

I think that was a mistake.

Another major area that has to be given a great deal of consideration is complying with the Federal Managers' Financial Integrity Act (FIA). This is an act that Congress passed some years ago, which requires that the heads of agencies have their internal controls reviewed and make a public statement as to the status of those controls; and then to also come up with a plan of action as to what is being done to improve them.

And I think, in the FIA reports that we had on HUD, it was clear that there were a lot of serious problems. There were some indications in these reports that we had vulnerabilities that later have proven to be realized, and people have been able to take the assets of the organization.

And so this Financial Integrity Act, I think, has to be taken very seriously. It is an annual report on the entity's internal control structure and I believe it should be built into the entity's annual financial report.

We've done that ourselves at GAO. It is a very good way of getting on top of your operation to know whether you have the proper controls in place or not.

We issued a management report on HUD in 1984 where we identified these problems, and I think that was one of the main reasons that there was movement at HUD to try to make improvements.

So I'm not discouraged here. I know we've had some real problems at HUD, but I really think that we had a program in the last couple of years of getting back to some decent financial records and an annual audit.

I talked to Jack Kemp yesterday and told him exactly what we were going to be reporting today, and he gave me every indication that he wanted to meet with me in the next week or so to make sure that he understood what we were recommending.

He also indicated that he would probably be very anxious to agree to strengthen these controls, and to issue an annual report that he can demonstrate personal leadership on the need for proper controls. You've got to have that if you're going to run such a large financial operation as FHA or HUD itself.

Mr. Chairman, that really is a summary of what we feel the problems have been in the past few years. The fact is that we have an 1987 audit that is complete, as you mentioned in your opening statement, but it was only a balance sheet audit.

We will have a complete audit for 1988 at the end of September. There will be a lot of problems reported in that audit. I don't want to kid anybody. The report will include a complete set of financial statements, a report on the internal controls, and a report on compliance with regulations and laws.

And I think, at the hearing which I know you're planning to hold, we'll be able to tell you where things stand as of this point in time.

So we'd be pleased now, Mr. Chairman, to answer any questions.

I might point out that I have with me Brian Crowley and Johnny Ols of GAO, and Tom Craren of Price Waterhouse. We're ready to answer any questions you might have.

[The complete prepared statement of Charles A. Bowsher follows:]

United States General Accounting Office

GAO

Testimony

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# GAO Audits of Accounting and Financial Management Systems at the Federal Housing Administration

Statement of
Charles A. Bowsher
Comptroller General of the United States

Before the
Subcommittee on Housing and Urban Affairs
Committee on Banking, Housing and Urban Affairs
U.S. Senate



Mr. Chairman and Members of the Committee:

We are pleased to appear here today to discuss GAO's efforts to conduct financial statement audits at the Federal Housing Administration (FHA) and the financial management problems at FHA that we have previously reported.

FHA and the Department of Housing and Urban Development (HUD) have received a great deal of publicity recently regarding various accounting and financial management problems. We have reported many of these types of problems for years. In addition, HUD's Federal Managers' Financial Integrity Act reports have consistently disclosed material weaknesses in FHA and HUD internal controls. FHA's serious accounting and financial management problems have been well documented in all of these reports, as well as in HUD Inspector General reports. Many of the problems have been long-standing. We have found that many of the deficiencies cited in earlier reports continue to be found in our more recent reviews.

Correction of FHA's problems will require multiyear solutions and a long-term management commitment. Strong action is needed by top management to address the very serious problems that continue to affect FHA. An action plan with milestones needs to be developed and implemented with independent monitoring and audit, particularly annual financial statement audits, to

ensure that progress is achieved and any obstacles are identified so that early resolution can be reached.

Before I get into the details of our various financial statement and program reviews, let me spend a few minutes discussing some background related to FHA.

BACKGROUND

FHA was established in 1934 under authority granted to the President by the National Housing Act (Public Law 73-479). In 1948, FHA became a wholly owned government corporation subject to the Government Corporation Control Act, as amended. FHA and its functions were transferred to HUD in 1965. After the transfer, FHA no longer had separate staff or facilities; its operations have been conducted, along with other housing activities, by HUD organizations.

The basic purpose of FHA programs is to encourage improvements in housing standards and conditions, provide an adequate home financing system through mortgage insurance, and exert a stabilizing influence on the mortgage market. To carry out this purpose, the Secretary of HUD administers FHA through four separate funds for its various mortgage insurance programs--the Mutual Mortgage Insurance Fund, the Cooperative Management Housing Insurance Fund, the General Insurance Fund, and the



Special Risk Insurance Fund. As of September 30, 1987, FHA had $277 billion of insurance-in-force and net government equity of $1.2 billion. The Mutual Mortgage Insurance Fund, which is intended to be self-financing, is the largest fund with $205 billion of insurance-in-force and government equity of $3.4 billion as of September 30, 1987.

EFFORTS TO CONDUCT FINANCIAL STATEMENT AUDITS

FHA became subject to annual audits by the Comptroller General under the Government Corporation Control Act in 1948. In 1974, the Government Corporation Control Act was amended, and the requirement for an annual audit was changed to require that an audit be made at least once every 3 years.

Our fiscal year 1974 financial statement audit resulted in our issuance of an unqualified opinion indicating that, in our opinion, the financial statements presented fairly, in all material respects, FHA's financial position and results of operations in conformity with generally accepted accounting principles and with applicable federal laws. This was the last unqualified opinion issued on FHA's financial statements.

In 1975, serious problems with FHA's financial management operations began to surface. From 1975 until recently, we were not able to conduct full financial statement audits of FHA

because of very serious accounting and internal control deficiencies which prevented FHA from producing accurate financial statements. These deficiencies included unrecorded transactions, lack of detailed supporting records, and lack of reconciliation of several key accounts to detailed supporting records. For fiscal years 1975, 1976, and 1978, we issued disclaimers of opinion because we were not able to express an opinion on the fairness of FHA's financial statements.

For fiscal year 1981, due to continuing accounting and financial reporting deficiencies, we worked extensively with FHA to assemble a set of financial statements in accordance with generally accepted accounting principles. We issued a report to the Congress (GAO/AFMD-83-66, June 10, 1983), which included FHA's unaudited financial statements. We did not conduct an audit of the accounts because the effort to assemble the statements required a great deal of time and the additional time that would have been needed to gather evidence to support an opinion would have extended this audit into fiscal year 1984, the year of our next required audit. Also, the financial data would have been 3 years old.

In May 1984, we began our fiscal year 1984 financial statement audit, but terminated our efforts after several months because of the continuing serious accounting and financial reporting problems. We met with the HUD Assistant Secretary for



Administration and discussed the issues that needed to be addressed before we could conduct a successful audit. These issues included FHA's responsibility to

-- improve internal controls over the general ledger system to ensure it would generate reliable data,

-- test new computer systems before implementation to ensure proper operation, and

-- reconcile key financial transactions and account balances to the supporting detailed records.

The Assistant Secretary responded to our discussion in a letter dated December 6, 1984, and stated that she was in overall agreement with us and that she had already begun to address a number of the issues that we had presented. To help her resolve these issues, the Assistant Secretary hired several accountants from GAO who were familiar with FHA's financial problems.

To help us fulfill our audit responsibility for fiscal year 1987, we contracted with the independent certified public accounting firm of Price Waterhouse. Although improvements had been made to the accounting and financial systems, the magnitude of accounting and reporting problems still present made it impractical to audit FHA's consolidated statements of operations

and changes in financial position for fiscal year 1987. Therefore, Price Waterhouse's 1987 work focused on auditing FHA's statement of financial position as of September 30, 1987, so as to establish a baseline for a 1988 audit. For fiscal year 1988, Price Waterhouse will provide an opinion on a full set of audited financial statements, as well as reports on internal accounting controls and compliance with laws and regulations.

After FHA agreed to numerous adjustments totaling some $1.9 billion, Price Waterhouse expressed an unqualified opinion on the fairness of FHA's consolidated statement of financial position as of September 30, 1987. In our opinion, and consistent with the opinion of Price Waterhouse, FHA's statement of financial position was fairly presented. Our report to the Congress incorporated Price Waterhouse's report (GAO/AFMD-89-3, May 12, 1989).

The fiscal year 1988 audit is well underway and is expected to be completed by the end of August. Our report will be issued shortly thereafter. In addition to the opinion on the financial statements and reports on FHA's internal accounting controls and compliance with laws and regulations, Price Waterhouse is developing a separate report on those items identified during its audits which it believes management needs to correct. After the Congress returns from recess, I would welcome the opportunity to discuss the results of our work on the 1988 statements.



REVIEWS OF FINANCIAL OPERATIONS REVEALED SERIOUS DEFICIENCIES

In addition to our financial audit work at FHA, we have also performed reviews of various FHA programs and over the years have issued many reports that describe serious deficiencies in FHA's operations. The reports identified a wide range of financial management problems including internal control weaknesses, accounting system deficiencies, and management inattention. Many of the problems noted in our more recent reports are the same problems cited in earlier reports. Attachment I to this statement includes a list of these reports. I would like to highlight for you the problems we found during a few of our major reviews in the last several years.

-- In 1984, based on an overall general management review of HUD, we reported (GAO/RCED-84-9, January 10, 1984) that HUD's management information systems do not provide timely and accurate data necessary to establish accountability for, and control over, housing and urban development programs. One of these key systems involved the process for underwriting FHA's single-family mortgage insurance. We reported that, although HUD spends millions each year to gather data, much of the data cannot be relied upon for controlling and monitoring

programs, and information needed by managers is not accurate, timely, or readily available.

In addition to program functions, we found that accounting activities would benefit from better systems. Although HUD started automating its accounting systems in the 1950s, these systems are not fully automated and extensive manual effort is needed for accounting functions. Historically, these functions have received limited top-management emphasis and lower priority in systems development. The result has been, as stated in our report, that systems do not include the necessary internal controls to adequately protect against fraud, waste, and mismanagement; do not comply with GAO's principles and standards; and do not provide management with timely and accurate financial data needed for oversight, program implementation, and budgetary analysis.

-- In May 1985, we reported (GAO/RCED-85-4, May 13, 1985) that HUD needed to strengthen its internal controls over procedures for approving insurance on single-family home loans. We found that HUD relies on lenders to obtain and verify information needed to determine the financial capacity of borrowers to repay and does not independently



verify the credit information submitted by the lender, like other properly managed mortgage insurance programs.

Because HUD's single-family loan insurance program protects lenders from the risk that they will not be repaid, making an FHA-insured home loan is virtually risk free for the lender. Because of the weaknesses we reported in HUD's procedures, in a much-publicized case, a single lender was able to make many loans to home buyers who had no credit history and, in some cases, information regarding the identity of the borrowers and their financial qualifications was misleading.

-- In 1985 (GAO/RCED-86-22, October 8, 1985), we reviewed HUD's second-year implementation of the Federal Managers' Financial Integrity Act of 1982 (FMFIA). The act was intended to help reduce fraud, waste, and abuse in federal government operations by requiring agencies to assess and report annually on the adequacy of their internal controls and accounting systems. Our review found that HUD needed to improve its process of identifying, evaluating, and correcting internal control problems. Also, our review noted that HUD's systems were not in conformance with GAO's standards and requirements.





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-- In June 1986, in reporting internal control actions taken on the basis of recommendations made by the HUD Secretary's Single Family Task Force and in our May 1985 report, we found that controls over monitoring loan defaults and verifying loan data submitted to HUD by lenders still needed to be improved (GAO/RCED-86-172, June 3, 1986).

-- In September 1987, we reported (GAO/RCED-87-165, September 30, 1987) on the continuing weaknesses in FHA's home appraisal program. HUD's 1983 FMFIA report identified material weaknesses in its method of selecting and reviewing home appraisals, which opened the program to fraud and abuse, and contributed to FHA's mounting losses. Appraisals were inappropriately selected for review, reviews were inadequate, appraisers were used as reviewers, and computer controls over appraiser assignments were routinely overridden.

FHA has a mortgage monitoring system, and we have been reviewing FHA's management controls to ensure they are being implemented as intended to eliminate fraud, waste, and abuse. The early results of our review of the monitoring system show the following.



-- FHA's system is not adequate for monitoring regional and field offices, lenders, fee appraisers, and counseling agencies. The system does not include all necessary monitoring to ensure that lender quality control plans are adequate, sanctions are imposed for poor performance, and appropriate management uses are made of the results of monitoring.

-- FHA does not have a complete and reliable system for tracking audit findings and recommendations.

In addition to identifying breakdowns in FHA's management controls, I would also like to point out that our work has indicated that there are opportunities to reduce costs by improving program policies and procedures. For example, in April 1988, we reported that in fiscal year 1987 FHA lost $1.2 billion on the sale of properties acquired because of loan defaults, and we identified changes to improve controls over the foreclosure process to reduce costs. For example, we pointed out that FHA encourage lenders to obtain property deeds from delinquent borrowers willing to offer deeds in lieu of undergoing prolonged foreclosure proceedings which are costly to FHA. Based on our observations, HUD has implemented this and several other procedural changes that, if properly implemented, could result in multimillion dollar savings to the government.

CONCLUSIONS

I have mentioned a few examples of the many reports we have issued over the years describing various deficiencies in many of FHA's programs. FHA's accounting and financial management problems have been long-standing and well documented. Correction of these problems will require multiyear solutions and a long-term commitment by top management.

Although there are no easy fixes to the problems in federal financial management, the development of accurate and reliable financial statements is a very important step in addressing the accountability for assets, recognition of liabilities, and accounting for operations. I have often stated in testimony before the Congress that annual audits, including reviews of internal accounting controls and compliance with laws and regulations, would focus attention on an agency's major problems. To improve accountability, I strongly believe top management needs to develop an action plan with milestones addressing the improvements needed in FHA/HUD's accounting and financial management systems. The plan should also provide for the accountability and discipline of financial statements and the performance of annual financial audits. Agency management and the Congress can monitor HUD's progress through an annual review of the independent auditor's opinion, reports on internal accounting controls and compliance with laws and regulations, and



management's report required by the Federal Managers' Financial Integrity Act.

This concludes my statement, Mr. Chairman. We will be pleased to respond to any questions you or members of the Committee may have.

ATTACHMENT I

LIST OF SELECTED GAO REPORTS RELATING TO FHA--1975-1988

Housing Programs: HUD Policies to Minimize Costs in Acquiring Foreclosed Properties (GAO/RCED-88-141BR, April 18, 1988)

Weaknesses in HUD's Single Family Housing Appraisal Program (GAO/RCED-87-165, September 30, 1987)

Housing Programs: Agency Actions to Discourage Single Family Mortgage Insurance Fraud (GAO/RCED-86-172BR, June 3, 1986)

Debt Collection: Billions Are Owed While Collection and Accounting Problems Are Unresolved (GAO/AFMD-86-39, May 23, 1986)

HUD's Second-Year Implementation of the Federal Managers' Financial Integrity Act (GAO/RCED-86-22, October 8, 1985)

Stronger Internal Controls Over HUD Single-Family Mortgage Insurance Programs Would Discourage Fraud (GAO/RCED-85-4, May 13, 1985)





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Increasing HUD Effectiveness Through Improved Management (GAO/RCED-84-9, January 10, 1984)

Problems Continue in Accounting for and Servicing HUD-Held Multifamily Mortgages (GAO/AFMD-82-18, August 18, 1982)

Defaulted Title I Home Improvement Loans--Highly Vulnerable to Fraud, Waste, and Abuse (GAO/AFMD-82-14, December 7, 1981)

HUD Should Make Immediate Changes in Accounting for Secretary-Held Multifamily Mortgages (PGMSD-80-43, May 16, 1980)

Housing and Urban Development's Efforts to Improve Its Accounting System for Mortgage Insurance Premiums (PGMSD-80-27, March 19, 1980)

Delays in Implementing the Department of Housing and Urban Development's Accounting System for its Mortgage Insurance Program (PGMSD-80-37, March 4, 1980)

Weaknesses in Servicing and Accounting for Home Mortgages Held by HUD (PGMSD-79-41, August 16, 1979)

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Action Being Taken to Correct Weaknesses in the Rehabilitation Loan Program (PGMSD-79-14, March 14, 1979)

Weaknesses in the Department of Housing and Urban Development's Financial Management System (PGMSD-77-75, December 28, 1977)

Millions of Dollars in Delinquent Mortgage Insurance Premiums Should Be Collected by the Department of Housing and Urban Development (PGMSD-77-33, September 8, 1977)

Second Interim Report on Review of HUD's Accounting System for Billing and Collection of Federal Housing Administration Mortgage Insurance Premiums From Mortgagees (PGMSD-77-7, December 13, 1976)

Action Being Taken to Correct Weaknesses in the System of Paying Taxes on Acquired Residential Properties (PGMSD-76-24, November 26, 1975)

Need for Improvements in the Automated Payroll System of the Department of Housing and Urban Development (PGMSD-75-31, June 18, 1975)

GAO

# Estimated Cash Flow — Sources and Applications of Funds

| | | |
|---|---|---|
| **Project 4** | | |
| **Sources of Funds:** | | |
| Mortgage Loan | $6,549,000 | |
| **Tax Credit Proceeds** | **2,078,602** | |
| Other | 0 | |
| Owners Cash Investment | 45,882 | |
| Total Sources of Funds | | $8,673,484 |
| **Application of Funds:** | | |
| Acquisition Costs | $2,900,000 | |
| Development Costs | 4,021,947 | |
| Developers Fee | 804,389 | |
| Estimated Escrows and Prepaid Expenses (1.5% of Mortgage Loan) | 98,235 | |
| Gross Total Applications | 7,824,571 | |
| Less: BSPRA | (363,020) | |
| Net Total Applications of Funds | | $7,461,551 |
| **Proceeds To Developer at Completion of Development** | | |
| Estimated Proceeds To Developer | | **$1,970,440** |
| Estimated Proceeds To Developer Per Unit (209 Units) | | **9,428** |

# GAO Example of How a Break Even Rent Level Is Calculated

| **Rehabilitation of an Apartment (Cost Based on 800 Square Foot Unit)** | | **Yearly Tax Credit** |
|---|---|---|
| Land Cost | $ 2,000 | $ 0 |
| Acquisition Cost — Less Land | 20,000 | 800 |
| Rehabilitation Cost | 20,000 | 1,800 |
| Soft Costs — Including Financing Costs, Architectural Fees, Engineering Fees, Insurance and Taxes, and Sponsor's Administrative Expenses | 13,000 | 1,170 |
| | | $3,770 |
| | | **Cash from Tax Credit** |
| Total Cost | $55,000 | $15,269 |
| | | **Rent Needed When Tax Credits Used** |
| **Operating Expenses — Yearly Rent Needed (Annual Estimated Based on 800 Square Foot Unit)** | | |
| Capital Repayment @ 10%, 30 Years | $5,792 | $4,184 |
| Taxes and Insurance | 1,043 | 1,043 |
| Management, Maintenance, Repairs Utilities | 1,043 | 1,043 |
| Utilities | 724 | 724 |
| Total Annual Expense | $8,601 | $6,994 |
| Minimum Monthly Rent Required To Cover Operating Expenses | $717 | $583 |
| Potential Monthly Saving of Rental Subsidy Funds | | $134 |

Senator CRANSTON. Thank you very much.

Thank you for abbreviating your statement, which helps us to get to the discussion we have.

Mr. Craren, would you proceed first before we go to questions?

Mr. CRAREN. I was told that I was just here to answer questions. I do not have an opening statement.

Senator CRANSTON. Let me just start out, Mr. Bowsher. I think it is important to establish some basic matters at the start of an important inquiry like this.

These hearings will restore legislatively what we need to do to make dramatic improvements, needed improvements at FHA.

A number of complex issues will have to be examined. I want these hearings from the beginning to examine how problems with FHA are affecting our national housing goals.

While I'm addressing questions to you, Mr. Craren, if you have any comments on his response—pro, con or whatever—please chime in.

PURPOSES OF FHA

Mr. Bowsher, would you describe briefly the purposes of FHA? What's the importance of FHA within the country's home mortgage finance system?

Mr. BOWSHER. As I say on the bottom of page 2 of my statement, the basic purpose of FHA programs is to encourage improvements in housing standards and conditions, provide an adequate home financing system to mortgage insurance and exert a stabilizing influence on the mortgage market.

To carry out this purpose, the Secretary of HUD administers FHA through four separate funds for its various mortgage insurance programs.

The first one is the Mutual Mortgage Insurance Fund, the Cooperative Management Housing Insurance Fund, the General Insurance Fund and the Special Risk Insurance Fund.

Senator CRANSTON. What do you think we need to know and understand to the best of our ability about the structure of FHA if we're to come to grips with the nature and importance and the resolution of the problems we're going to be addressing?

Mr. BOWSHER. I think that people have to recognize that there was a major restructuring of HUD during the late 1960's and early 1970's. And then, later on, there was an even greater movement to rely upon the private sector.

And so, if you go in that direction, and there's no reason to say that it isn't do-able and workable, you have to have an adequate monitoring system to understand what's happening out there.

We don't have today a separate FHA entity within HUD. We have people within HUD that are administering FHA programs and FHA funds.

And I think that the key here is to know what's happening as you administer these funds and programs.

You've got to have adequate monitoring; you've got to have adequate feedback; and you've got to have annual financial audits to know where things stand.

I think then that HUD has to report to the Congress on all this. I would recommend this as part of an annual oversight process.

Senator CRANSTON. As you note in your testimony, Mr. Bowsher, the General Accounting Office is required to audit FHA's financial statement. Originally, GAO conducted annual audits. Then, in 1974, the law was changed to require audits every 2 years, as you have noted.

Before we get into more detail, it would help if we would start with some basics.

FUNCTION OF A GAO AUDIT

Would you briefly explain the function of a GAO audit?

Mr. BOWSHER. GAO does a variety of audits. One is a financial audit. That's where you look at the financial statements, you look at the internal controls, and you look to see how the laws and the regulations have been complied with.

Another is a program audit, where we go in and look to see how programs are working. We generally review the efficiency and effectiveness of programs.

We also do management audits. In other words, we review how well the department is being managed.

Now, what we're talking about today with regard to FHA are financial audits. In financial audits, what you're trying to do is see whether the assets and the liabilities are properly stated on your financial statements, whether the income has been properly reported for the year, and what is the status of your internal controls and systems.

And I think it was a mistake, Mr. Chairman, to go back to the mid-1970's when we said we only audit every 3 years. And I think that a change should be made: to require annual audits.

Senator CRANSTON. Running together several questions on this, what work is involved in a financial statement audit?

What benefit is a well-conducted audit intended to provide to the Congress program managers and the public?

And what dangers is an audit designed to avoid?

Mr. BOWSHER. The financial audit is basically to tell you where you stand financially. In other words, what are your assets, what are your liabilities, what is your equity position.

It's generally done at the end of a fiscal year or a calendar year, and follows Government auditing standards, which we prescribe. We also ask that the auditor look at the internal controls and the systems to see if they are adequate, and identify any problems there; and also, of course, the extent of compliance with laws and regulations.

Now, program managers, as financial audits are being conducted, ought to look and see what problems are being reported:

In other words, are there big write-offs?

Are there internal control weaknesses?

What problems has the auditor run into in conducting the audit?

That should all be presented at the end of each audit.

Senator CRANSTON. Your testimony states that 1974 was not only the last annual audit of FHA, but it was also the last year the GAO auditors gave an unqualified opinion that FHA's financial

statements fairly presented FHA's financial position and the results of FHA operations.

In 1975, 1976 and 1978, the GAO issued disclaimers saying it couldn't attest to the fairness of FHA's financial statement.

Then, in 1981 and 1983, the GAO audits were frustrated completely and had to be terminated because FHA's financial accounting and financial reporting problems had become so serious.

That situation is clearly unacceptable. State of the art financial accounting is vital in an agency which deals with such large volumes of funding and credit risks, as FHA does.

Could you set the problem in context? How unusual is it for GAO to issue disclaimers with respect to the audits of a federal agency?

How unusual is it for GAO to terminate audits because of accounting problems such as those found at FHA?

Mr. BOWSHER. It is not often that we issue a disclaimer, but we do issue disclaimers from time to time where we feel that the financial statements don't really tell what the financial position is. Or, if you can't get sufficient records together so as to determine what the financial position is.

So, when that happens, the auditor should not give a clean opinion but should issue a disclaimer. I think, as you saw in the S&L crisis, we found some CPA's that did give clean opinions, and shortly thereafter, there were obvious problems. So, maybe in those cases, disclaimers would have been more appropriate.

We conduct our audits very carefully and at the end we give either what's known as unqualified opinions or clean opinions.

But, if we can't do either, then we issue a disclaimer.

When you go in and find the records so bad that you can't do the audit, that's when you just say to the institution you're trying to audit:

We can't do an audit. You've got to get these records straightened out before we can begin to audit.

And, of course, that's where we were with HUD up until the mid-eighties, until the agency finally decided to do something about it.

Then in 1987, we were able to go back and begin to do an audit. So it's very serious when we walk away and say we can't do an audit—it means things are in terrible shape.

Senator CRANSTON. Is it just a coincidence that the GAO has been unable to issue an unqualified opinion since the shift away from annual auditing?

Mr. BOWSHER. I think it is somewhat of a coincidence. But, at the same time, as I said earlier, I really believe an annual audit makes a lot of sense in larger institutions, especially in this computer age. In the computer age, people can change programs so quickly that if you're not checking the systems once a year, I think you're taking a big risk.

So I really do believe that we should return to annual financial audits of Federal agencies and corporations.

Senator CRANSTON. To what extent have the problems of FHA been exacerbated by the change to a 3-year audit cycle?

Mr. BOWSHER. I think, at first, it might have been that management would have been given prompt notice about the problems that they were getting themselves into. In the 1980's, it wouldn't

have made much difference because they were already deep into a problem of not having adequate records and systems.

But, going back to the mid-1970's, if we had had annual audits, there might have been more timely warning as to the magnitude of problems that were developing.

Senator CRANSTON. GAO has entered into a contract, as you know, with Price Waterhouse to correct FHA's accounting problems and to bring FHA's accounting system into a conformance with generally-accepted accounting principles.

Would you please describe the relationship between GAO and Price Waterhouse? What is the scope of the work that Price Waterhouse is carrying out?

What are the objectives? What work has been completed? What's now underway? What's the time table?

Mr. BOWSHER. All right. Mr. Chairman, we do not have enough people to do financial audits of all the agencies that should be audited. So, I went to the Congress early in the 1980's and told them so. I said that I thought one way we could do it would be to have the funds that we could contract with CPA firms to do some of this work.

Congress went along with that. I think it was a very good decision. So we went out on a competitive bid and selected Price Waterhouse to do the HUD audit.

The relationship between GAO and Price Waterhouse is that they do the audit and we review it. So that both HUD and the Congress will get both their work and our review of their work in a report at the end of the audit.

Now, as I say, they did only an audit of the 1987 balance sheet. In other words, we were able to get an opening yardstick as to where everything stood.

Then, in 1988, for the audit that is currently underway, they are doing a full audit that includes not only the financial statements but reviews of internal controls and laws and regulations.

When they report to us in another month or so, we should have what you would call a full audit for fiscal year 1988.

Senator CRANSTON. Mr. Craren, do you have any comment on any of the responses of Mr. Bowsher?

Mr. CRAREN. No, Mr. Chairman.

Senator CRANSTON. Al, I'll turn to you at this point.

Senator D'AMATO. Thank you, Mr. Chairman.

Let me ask you, given the limited nature of the audit as you've done it and the fact that you're still working on the 1988 audit, is it too early to anticipate what the losses in FHA are at this time?

AMOUNT OF LOSSES IN FHA

Mr. BOWSHER. There were write-downs in the assets in 1987 which reduced the equity from $3.1 billion to $1.2 billion. That was primarily in the general insurance and special risk insurance fund.

The largest adjustment was $1.1 billion, which resulted from a more timely reporting of insurance losses, so that the FHA's financial statements would conform with generally-accepted accounting principles.

And then other major adjustments reduced FHA's equity by $172 million for additional estimated losses in disposing of foreclosed properties, and $178 million for additional losses and discounts on single and multi-family mortgage loans.

That was 1987. For 1988, there are also going to be some substantial adjustments because some large co-insurers have gone under. While we don't expect any more large one-time adjustments as we had in 1987, there is no question we are going to have some adjustments from the 1988 audit. We don't have the final figures, but I think you can see that, in the 2 years, the equity has been hit pretty hard.

Senator D'AMATO. That was my next question. What was the period of time in which the adjustment went down? Does that cover a 2-year period? Or would it go back?

Mr. BOWSHER. When you did the balance sheet audit of 1987, you literally went back and said:

What's happened up to 1987?

So your opening balance for 1988, as of the end of 1987, was established so that you would have an accurate statement of the assets and liabilities at the beginning of the audit.

Senator D'AMATO. So we're talking about a period of how many years that these losses have occurred, or these adjustments? Is it 2 years? 3? 5?

Mr. BOWSHER. It could have been several years.

Senator D'AMATO. Could it go back to the 1970's?

Mr. CRAREN. I would say that for the most part, what we did was base our largest big adjustment on the instant of default rather than on the payment date. That's about a year lag.

Senator D'AMATO. So it's several years.

Mr. BOWSHER. So I think it's mostly in the 1980's, you might say, the mid-1980's.

Senator D'AMATO. It covers the mid-1980's to the end of 1987?

Mr. BOWSHER. That's correct.

Senator D'AMATO. OK. And you say, in 1988, you don't anticipate any really major kind of drop that we've seen this audit indicate?

Mr. BOWSHER. No, except in 1988, there were a couple of mortgage groups that went under.

Mr. CRAREN. There were large mortgagees in the co-insurance programs that went under in 1988, although we don't know the financial impact yet. This could impact the financial statements.

Senator D'AMATO. Could that take the fund and put it into a negative position?

Mr. CRAREN. These programs are in the general insurance fund, which is already negative, not in MMI. But don't know the magnitude of them yet, as I mentioned.

Mr. BOWSHER. If I could just add to that, Senator, you have a net $1.2 billion equity balance at the end of 1987. The big fund, the MMI fund, has got over $3 billion, but, two funds, the GI fund and the SRI fund, are in a negative position, as Tom points out.

You can get a good picture of it from page 23 of our report on the 1987 audit.

Senator D'AMATO. And that puts us in a plus position if you add them all up?

Mr. BOWSHER. If you add them all up, you're in a plus position, but you've got two funds that are in a negative equity position even before the 1988 audit.

Senator D'AMATO. Will you be making recommendations as to how to deal with them as part of your audit?

Mr. BOWSHER. I think we will be looking at that as part of our 1988 audit.

Senator D'AMATO. Some have implied that FHA will become another FSLIC. Is that a valid comparison?

Mr. BOWSHER. I think that's an over-statement. I think what you're seeing here is some billion dollar problems. But, if you remember, FSLIC is a multi-billion dollar problem. I think the first year at FSLIC we had an $8 billion adjustment; then we had over a $10 billion adjustment. And this year, it's going to be horrendous.

So while I think these problems are serious and should be addressed, I don't think they're in the magnitude of FSLIC.

IMPACT OF FHA LOSSES

Senator D'AMATO. What sort of impact do the FHA losses have on the Federal deficit, if any?

Mr. BOWSHER. As you have to appropriate funds to deal with these problems, you would affect the budget.

Brian, would you want to add anything?

Mr. CROWLEY. To the extent that we have to pay out more money to cover these losses, you would have an impact on the Federal deficit.

Senator D'AMATO. So it's the actual payment of those losses.

Mr. CROWLEY. If you have to make good on loan guarantees, then it will affect the budget, yes.

Senator D'AMATO. One final question, and you've heard me pose it to C. Austin Fitts, that we'll get into Thursday.

There is a provision in the Cranston-D'Amato bill, S. 565, which raises the mortgage limits in the high cost areas, taking it from $101,000 to $130,000 or $140,000, depending on what the average cost of houses is in that area. Some people believe that this provision could possibly benefit the fund by allowing higher income buyers to participate, resulting in an increase in premiums by those people who are most likely to continue that fund in a solid position.

Some critics, however, say that this alteration indeed may not increase revenues to the fund.

Have you had an opportunity, and this may be unfair to look at that——

Mr. BOWSHER. No, it's a very fair question, Senator. Johnny Ols is on my extreme right here. He's doing the program work in this area, and we are studying that. We would hope to have answers for you in September on that, too.

Senator D'AMATO. Wonderful.

Mr. Chairman, I have no further questions.

Let me commend Mr. Bowsher for moving as expeditiously as he has, and for bringing in Price-Waterhouse to help in this.

We certainly look forward to your recommendations, particularly as they relate to what we can do and what should be done.

I know Secretary Kemp will probably go along on that front.

Mr. BOWSHER. Thank you very much.

Senator CRANSTON. Thank you very much, Al.

Senator Pressler, do you have any questions?

Senator PRESSLER. I have a brief statement for the record. I apologize to the witnesses. I've been in about three committees this morning. I have a markup in Commerce and I'm catching up on my work here.

But I do have some questions for the record.

STATEMENT OF SENATOR JIM SASSER

Senator PRESSLER. Thank you, Mr. Chairman, for calling this hearing on the financial health of the Federal Housing Administration. Reports in the press have emphasized some disturbing findings from the Price Waterhouse/GAO audit for fiscal year 1987. Indeed, Government equity in the FHA fund was written down by $1.9 billion. The FHA single family insurance fund experienced its first cash losses in over 40 years.

However, a close reading of the audit is warranted. First, we need to distinguish between the performance of the single-family and multifamily programs. The multifamily programs have traditionally shown losses.

On the other hand, the single family insurance fund as of the end of September 1987, still had a positive equity position of $3.4 billion. The GAO also reported that since 1979, the trend has been toward FHA insuring better quality mortgages. Finally, the GAO reported that the single-family insurance fund is, and I quote, "in sound financial condition under probable future economic conditions."

At same time, Mr. Chairman, I do believe there is cause for concern and caution. HUD has the task of managing almost $1 trillion of Federal commitments. As recent revelations about "Robin HUD" and others have pointed out, it is clear that financial controls and other management systems at HUD have been inadequate. With that in mind, Mr. Chairman, we may have a problem that can be cured by improving management rather than altering or restricting the main thrust of different FHA programs. I am anxious today to learn more about the findings of the 1988 audit that is nearing completion, and to learn more from the experts before us today what legislative solutions we can pursue to tighten HUD's financial management.

Thank you, Mr. Chairman.

Senator PRESSLER. I guess one question I would like to ask on the record, if I may, and I'll address this to anybody, is:

Making housing more affordable seems to lead to lowering credit standards. If that were to be done, aren't we increasing the risks which ultimately fall on FHA, and does FHA or the Government have a policy with respect to seeking deficiency judgments?

Mr. BOWSHER. As I explained to Senator D'Amato here a little while ago, we are doing a program audit trying to answer some of these questions. We would hope to have that work completed by September and be able to report back.

Senator PRESSLER. You've covered that area already? I'll read the record.

Mr. OLS. I think the Senator is right. There is an effect. We're looking at the various trade-offs that Senator D'Amato mentioned about:

What about raising the ceiling? What effect would that have? What would you bring into the fund to cover various things through the insurance premiums?

So we're looking at all aspects of that to project out in 15 years what's going to happen with that fund.

Senator D'AMATO. If I might just intrude upon my colleague's time, could you also do that with a view towards not lowering the downpayment? In other words, the downpayment would be kept the same.

Mr. BOWSHER. In other words, do it both ways?

Senator D'AMATO. Do it both ways because I do have a feeling that maybe there is some justifiable concern. We are looking to try to give people increased opportunity for home ownership and there may be a very valid point that if you reduce that downpayment, you may be doing those young families an injustice, getting them in over their head.

Having said that, could you make that analysis as if the downpayment were kept the same, or maybe even slightly increased as it relates to increasing the FHA limit?

Mr. OLS. Yes. One of the things we are looking at is the movement of that scale. If you increased the ceiling, couldn't you also increase downpayment at certain levels? By 1 percent, if you're increasing the ceiling by 20 percent, for example.

Senator D'AMATO. In other words, you'll come in with some variables?

Mr. OLS. Yes, we will.

Senator D'AMATO. I thank my colleague.

Senator PRESSLER. I look forward to the response very much.

Senator CRANSTON. Could you describe the differences of purpose among the mutual mortgage insurance fund, the general insurance fund and the other funds of FHA?

How does the behavior of the balances of the different funds operate?

And the purpose is also some are expected I guess to lose money, are they not, while others are not expected to?

Mr. BOWSHER. That's right. Some are more special purpose programs and, therefore, have a greater risk, you might say. Let me just read this.

The FHA programs are organized into four major activities as follows:

One, the Mutual Mortgage Insurance Fund, often referred to as MMI, which provides basic single-family mortgage insurance, it is a mutual fund whereby mortgagors upon non-claim termination of their mortgages share surplus premiums paid into the fund that are not required for operating expenses and losses.

That's the big fund.

The number two fund is the Cooperative Management Housing Insurance Fund [CMHI], also a mutual fund which provides mort-

gage insurance for management type cooperatives authorized by section 213 of the National Housing Act.

Then, the third fund is the General Insurance Fund, sometimes referred to as the GI fund, which provides for a large number of specialized mortgage insurance programs, including insurance of loans for property improvements, as well as for cooperatives, condominiums, housing for the elderly, land development, group practice medical facilities and non-profit hospitals.

The fourth fund is the Special Risk Insurance fund, [SRI], which provides mortgage insurance on behalf of mortgagors eligible for interest reduction payments who otherwise would not be eligible for mortgage insurance.

SRI also provides insurance for high-risk mortgagors who normally would not be eligible for mortgage insurance.

Of course, that is the program that has the higher risk.

Senator CRANSTON. Thank you very much.

Mr. Craren, I much appreciate your appearance before our subcommittee this morning, and I'm finally getting to you. You've been invited because of both your professional expertise and your personal experience in working with the FHA audit over a good many months now.

This morning's hearing, as you know, begins the subcommittee's exploration of the problems of FHA. It would be useful at this stage if you would feel free to give your own opinion based on your own extensive experience.

If you do that, we'll understand that your comments may not be the formal opinions at this stage of Price Waterhouse.

When you started the audit of FHA's financial statements, what were the most frightening problems you encountered? If you'd give us a few examples of that.

And how does your experience at FHA compare with what you've found at other Federal agencies?

Mr. CRAREN. First, Mr. Chairman, I want to say that FHA got as far as it did because of dedicated civil servants who tried to do their best in a rather difficult environment.

You alluded to that in your statement.

The problems we saw are not untypical. There's still a big concentration on cash inflows and outflows and not really on those aspects that are important to an insurance operation.

For example, there's not enough attention, I think as others have mentioned, on monitoring the underwriting, particularly the appraisals. There's also, I think this has also been mentioned throughout, not enough monitoring of the property management function; and monitoring of the agency-held property also needs work.

We found a number of instances where there just wasn't enough staff. The economic problems in the southwest, for example, have flooded those offices with properties and made their jobs more difficult. They could not do the monitoring that they probably should have with respect to the management and subsequent sale of the property.

So those were the major things that we came in and saw problems with very quickly.

Senator CRANSTON. I'd like each of you to feel free to answer each of the other questions that I have to put to you this morning. So, whoever feels like answering first, please do so. Then, if the other wishes to express any different point of view or any different emphasis, it would be helpful if you would point that out.

We learn more when we hear some differences than when we don't, when they're in order, of course.

First, can you describe the general nature of the financial accounting problems of FHA?

What are the major issues of concern?

MAJOR ISSUES OF CONCERN AT FHA

Mr. BOWSHER. The major concerns in the financial management area is the lack of internal controls—the fact that the systems were not installed well.

And I think that when HUD and FHA entered the computer age, like a lot of Government entities, and even some organizations in the private sector, they were taking on technology that should have been very helpful, that should have given them much more capability. But, it won't if you don't install it properly.

So I think you have a fair number of systems at HUD that have a lot of installation problems. There was a lack of internal controls and problems in developing and testing their computerized systems. Also, the ability to reconcile critical accounts is essential to knowing where you stand with your financial statements.

These were the major problems.

And may I also point out, Mr. Chairman, that we see these problems in a lot of Government agencies. I really think that we have serious problems. I have issued reports to the Congress on the serious problems in many of the Federal agencies where we have potential problems very similar to what has happened here at HUD.

And I think it's a problem that the administration should take note of and do something about.

Senator CRANSTON. Would you separately give me a listing of those agencies where you think there are problems?

You don't need to do it now.

Mr. BOWSHER. Yes, I'd be pleased to do it.

Senator CRANSTON. Send me a memo on it. I'd appreciate it.

Mr. BOWSHER. I think this is an area of vulnerability for the Congress and for the administration that should not be allowed to go on. I think, if it's allowed to go on as it was at HUD during the 1980's, I think everybody takes a big risk that, at some point in time, you're going to have major troubles.

Senator CRANSTON. Any comments on that?

Mr. CRAREN. I agree with that. I would also add that the problem was made more difficult at FHA because of staffing. It was in a difficult situation in our view. I think what was hurt the most was the monitoring function, which is probably the most important function given the type of business they operate.

Senator CRANSTON. What do you believe were the major causes of the problems and to what degree were the problems caused by changes in policy? By changes in management practices? By reduc-

tions in staffing? By the general failure to modernize and adapt the changing demands on FHA? Or what other problems?

Mr. BOWSHER. I think all of those were contributory. I think also that another major cause was the lack of management commitment for a number of years. In these large organizations, if top management really wants to get on top of their problems, they must make a commitment to address them.

Also, I think you have to recognize that in this day and age of computers, you have to have people with the proper skills. In other words, having just a quantity of people doesn't do it. So you have an organization here that took fairly substantial staff cuts and, in addition to that, probably didn't have the skills within the staff that remained to get the job done.

And I think that's what's going to have to be done here. I think you're going to have to have management come up with a plan that's probably going to take 3 or 4 years. An investment will have to be made to straighten all this out. And I think that top management and the budget people over at OMB are going to have to support it, or you're just not going to get corrections in the systems and management that's going to be needed.

Senator CRANSTON. The GAO has reported accounting problems at FHA for a long time. And it must be frustrating for you to point these out and have nothing much happen.

Why do you think no action has been taken?

Mr. BOWSHER. I think it was very frustrating, and we have certain agencies like this. The inaction was that they were trying to cut down on the budget. They were trying to move it into the private sector on the assumption that they didn't have to monitor it, which I think is always a fallacious assumption. I think any time, even in the private sector, you have a major company that goes out and subcontracts a part of the operation, they've got to have the skills to monitor what's happening out there with their subcontractors.

The Government is the same. And so I think it wasn't until a couple of people at HUD in the latter part of the Reagan Administration finally started to realize how serious this problem was and we were able to talk them into making some improvements in the accounting area.

I think, in the monitoring area, they apparently weren't as convinced, and I think that's one of the reasons why you had the problems explode at HUD.

Senator CRANSTON. Recently, the news has highlighted the bizarre story of an FHA management agent, nicknamed "Robin HUD", because she allegedly stole as much as $5.5 million of HUD funds and gave much of it to various charitable activities.

The amazing thing is she was able to embezzle that amount of money over a period of 3 years without anyone at HUD seeming to notice that that was transpiring.

The news media reported stories of incredibly chaotic cash management practices—large checks lying around in various desk drawers at HUD area offices for days and weeks without being deposited.

What have you learned about the program management and financial management at FHA that would explain how these conditions could have arisen and festered like that?

Please be as specific as you can.

Mr. BOWSHER. I'd like Brian Crowley to answer that question, Mr. Chairman, because when we went back and looked at their financial integrity reports, the vulnerability was clearly stated there.

I'd like him just to read it. It's very short and I think you'll get an idea of how much on notice everybody was that this could happen.

Mr. CROWLEY. Mr. Chairman, this comes from the report dated December 31, 1987. One of the problems that was noted in HUD's FMFIA report related to the single-family property disposition sales program. In this process, private closing agencies were used to close mortgages secured by buyers of Secretary-held properties.

Inadequate controls existed which allowed the potential for closing agents to manipulate or otherwise take funds for their own use, and to delay the transfer of such funds to the Department.

That's what the situation was with "Robin HUD."

The situation here in this report is that:

Largely, this warning went unheeded.

Senator CRANSTON. Thank you very much.

Mr. CROWLEY. Tom, didn't you find the same thing during the 1987 audit?

Mr. CRAREN. That is right. There's a lack of what I call surveillances. If you're delegating that much authority over an agency's cash, there's a need to provide a sufficient level of surveillance over property sole collections. Collections were also untimely. And there were other instances where the money wasn't being deposited.

So I think FHA needs to do something to improve the systems that monitor cash flow.

Senator CRANSTON. Mr. Ols, if you want to chime in at any point?

Mr. OLS. Thank you.

Senator CRANSTON. Another emerging scandal relates to the maladministration of the co-insurance program. HUD's Inspector General has found that some co-insuring lenders were not adequately complying with HUD's underwriting and servicing requirements. Lenders were underwriting unsound loans, over-mortgaging properties, failing to detect indication of troubled loans in a timely manner. And not taking adequate and timely actions to minimize defaults and losses.

Nearly $700 million in co-insured mortgages are now in default. And the activities of one co-insuring lender alone may cost FHA some $300 million.

Is this a case of misguided policy, or is it a failure of implementation?

Is FHA adequately staffed to administer the co-insurance program? What is it about the program or financial management at FHA that could have permitted the problem of this magnitude?

Mr. BOWSHER. I'd like Tom to answer that question.

Mr. CRAREN. Mr. Chairman, I think there's two real issues here. The first is that these are large multi-family projects that have very complicated mortgage underwriting. So the first problem is having a sufficient body of experience to do a proper amount of monitoring and oversight of the underwriting, to get back to that issue.

There are other issues with the program that HUD is studying right now. There are questions about whether the capital level is appropriate and whether financial information is being reported properly to HUD. That is also under study right now.

And in terms of flaws in the program, I think we have to wait until that study is complete.

FIRE SALE PRICES

Senator CRANSTON. Mr. Craren, other alarming reports relate to FHA sale of the properties. A number of cases have been revealed in which FHA sold multi-family properties at fire sale prices only to see the buyers resell the property at enormous profit.

Those funds should have gone to FHA to lessen the exposure of the taxpayers.

What factors in FHA led to that outrageous loss? What policy? What pressures on FHA management? What staffing?

Are those losses still a danger given that background?

Mr. CRAREN. There is something of an investigation on that right now focusing on whether there was some fraud involved. But I think there is pressure from a cash standpoint to move properties, whether they're multi-family or single-family properties. And I think that at least may have contributed partly to the problem.

I don't think we're in a position yet to know how severe the problem is or how much it will ultimately cost FHA.

Senator CRANSTON. What leads to a fire sale disposition of property when more could be obtained for it?

Mr. CRAREN. It's the old emphasis on cash. The way FHA was managed was to bring cash in as quickly as possible, particularly given the deficit situation. I think there was some pressure exerted to do that.

So they didn't focus enough on how much was realized when the property was sold, but rather on how rapidly you could bring in cash.

Senator CRANSTON. If you get more cash by a wee bit of patience, I don't understand. [Laughter.]

Mr. CRAREN. I think people were very impatient for a while. But I think it is endemic of the cash focus. That sounds like the case at FHA. There is a push for cash management rather than whether you're making a sound sale. Or, in fact, even getting a profit on the sale.

Senator CRANSTON. Another problem is that a number of sales in a given area at fire sale rates can depress the market and everybody winds up losing, including not only FHA but other property owners.

What lessons might be learned from this that we can apply to the Resolution Funding Corporation that's going to be set up by the FSLIC?

They're going to have a vast amount of property in their hands. And there's great concern on my part that they may similarly be in a rush to dispose of the property and may dispose of it at fire sale prices, reducing the protection to the taxpayers and depressing the market prices in areas with many disastrous results.

Any suggestions on how we can help make sure that doesn't happen with the Resolution Funding Corporation?

Mr. BOWSHER. I don't have many suggestions, but what I do know is that we're going to be asking that it be monitored very closely as part of the legislation. I think it's one of the serious problems.

This whole RTC is going to present many difficult problems for whoever heads that up. I think it's going to be one of the toughest jobs in Washington because of the very issues that you've raised, Mr. Chairman. You're going to have a tremendous amount of property. You're going to have to try through good judgment to come up with the right pace of selling off this property without depressing the entire housing market in certain areas. And then you're going to have to avoid scandals.

In other words, I think one of the big problems here is to make sure that fraud and influence peddlers don't get into the system.

So I think you've put your finger on a very tough issue here for all of us for the next few years. And on some of the problems that Tom talked about will be facing the RTC.

Senator CRANSTON. Mr. Craren, any comments on the Resolution Funding Corporation and the problems that might be facing it?

Mr. CRAREN. Happily, I'm not involved with that. [Laughter.]

Senator CRANSTON. Is there a problem in the structure of HUD that has led to these difficulties?

Mr. BOWSHER. I think the structure problem basically is this concept of having the private sector do most of the work, be in control of the funds, and be responsible for the paperwork and everything, and then not to have it properly monitored.

I think FHA and HUD have just got to set up a problem monitoring system here. And I think Ms. Fitts is aware of that from listening to her comments about how surprised she was for lack of information when she arrived.

So I think, if I have to say there's one key area of organizational change, it has to be the desire of management and HUD and FHA to properly monitor what's going on, even though it's being done by the private sector.

Senator CRANSTON. I'd like to put this question to both of you, but first to Mr. Craren.

Your intense review of FHA's financial condition has uniquely positioned you to assess developments or signals that should be cause for concern.

I'm interested in your perception of the reported changes in the business environment of FHA, or important changes in the performance.

What developments do you see as possible indicators of future trouble for the operations of FHA? And do you see reasons for concern about continuing financial viability of FHA?

If so, what are the reasons and what should we do?

Mr. CRAREN. I think that our main concern is that we feel FHA operates in a very complex environment. The financial markets are sophisticated and FHA is going to have to respond to them. That puts an added burden on them.

And I think you respond to that by developing people who are trained and capable of running the programs properly. Our feeling is there has to be some response to market sophistication or else you continue to run the risk of what we've seen happen in the past several years.

I think, structurally, although I don't know how much more specific I can get, we do think it's a complicated market, particularly when you're talking about some of the complex multi-family and hospital loans, some of the largest loans FHA insures.

In terms of the viability, we are awaiting anxiously the outcome of some studies that are going on. All I can tell you is that that's very important to us in our audit this year. And we're really not yet in a position to know whether FHA is in trouble.

Senator CRANSTON. Mr. Bowsher.

Mr. BOWSHER. I think Tom gave you a good summary. I would only add two items on viability. One is the rising default rate and the second is the fund deficits. As these deficits climb, I think it is a worry as to future viability, and I think that will have to be addressed.

Senator CRANSTON. As I indicated earlier, I suspect that many of FHA's recent difficulties have been caused not simply by misconduct of individuals, but by more systemic weaknesses in FHA.

Serious problems can evolve over the years, it seems to me, if FHA's structure and operating methods haven't kept apace with profound changes in the economy and in the mortgage markets.

As you just indicated, what underlying structural problems of FHA do you think are the greatest causes of concern? Do you see any systemic weaknesses in the program structure or methods of operating, or staffing problems or other major structural problems that need to be addressed if FHA is to once again be effective?

If you can give any examples, it would be helpful. Can I start with you, Mr. Craren?

Mr. CRAREN. Yes, I think we talked earlier about some of the most important structural aspects. I think also, that in the environment in which FHA operates it is important to study the financial aspects of the loans FHA insures. And the size of the downpayment is a very important aspect of any study.

Credit quality is very important. But equally important is making sure that FHA is organized to deal with what I think are some very sophisticated operators in their environment. The lenders with whom they deal.

They should have qualified people to deal with them effectively.

Senator CRANSTON. Mr. Bowsher?

Mr. BOWSHER. I think that's a good summary.

Johnny, do you have anything?

Mr. OLS. Other than that, monitoring is the key. It's not so much the organization and structure of headquarters but the actual monitoring of the lenders that you've turned over the entire governmental insurance program to. I really think that's the key.

It's not so much how you organize headquarters-wise. And that's what was lacking, as Tom said. That comes through loud and clear each year we go back over the situation.

Senator CRANSTON. We've been hearing dramatically different estimates of the safety and soundness of the FHA fund. Some claim that the FHA fund is sound. Others are claiming that the FHA may become another FSLIC.

Unfortunately, most of these reports come from sources that just can't be completely objective. The very fact that intelligent people can come up with different assessments of FHA's situation is itself reason for some concern.

I understand that your report will not be ready to release for several more weeks, but to what extent may the various reports of alarm or comfort be misleading?

What can you tell us about the financial condition of FHA and about its continuing financial viability?

What are the magnitudes of the costs of any problem that we should be concerned about?

Mr. BOWSHER. As I said to Senator D'Amato, I don't think it's in the category of FSLIC, although there are some underlying problems that are similar.

I think, back in our report that we issued in May of 1989, we said that, as of fiscal year 1987, both a HUD actuary and an independent contractor hired by HUD concluded that the fund was in sound financial condition, based upon historical trends and their assessment of probable future events, based on the results of an economic stress test.

The independent contractor further indicated that the fund, one, would barely survive under more severe regional stress; and, two, would not survive under national stress without U.S. Treasury support.

So I think the look-see that was given at that time has provided some warning signs that should be given a good deal of consideration.

I think the fund is in OK shape right now. But, with these continuing defaults, and if we were to go into a recession, as pointed out in the report, this fund would be in trouble.

Senator CRANSTON. What do you think needs to be done to ensure that Congress gets reliable and useful information about the fund from now on?

Mr. BOWSHER. I think the annual report and the annual audit from HUD on FHA's operations and financial situation is absolutely essential for you to know where things stand.

I would build in the Financial Integrity Act Report. We've done it in our own annual report that we give to our oversight committee.

What I'd like to do, Mr. Chairman, is give you a copy of that report and show you an illustration of the type of reporting I'm talking about. I plan to give it to Jack Kemp when I meet with him in the next few days, as an example of the type of an annual report to the Congress that I think starts to tell where you stand, what your problems are, and what you plan to do about them.

Senator CRANSTON. Mr. Craren, any comments?

Mr. CRAREN. No, I agree with that summary.

Senator CRANSTON. I'd like to ask you very candidly about your views on the magnitude of changes you believe should be made at FHA. I recognize you may not be ready to go on the record yet about detailed reforms you may recommend in the weeks right ahead of us.

But, is it your current view that FHA problems can be resolved with relatively minor or routine improvements in FHA's activities? Or do you believe major reforms are needed?

Please be as specific as you can.

Mr. BOWSHER. If I could, Mr. Chairman, I'd like to defer the answer to that until September, when we have the results of the financial audit and the results of Johnny's program work.

I think we can be very specific at that time. In other words, I will be able to answer your question. But I think it would be premature for me to answer that now without the results of that work.

Senator CRANSTON. Do you have any comments, Mr. Craren?

Mr. CRAREN. No, I agree with that. I think there are a number of other areas that have to be studied before we can get into any detail on this issue.

Senator CRANSTON. Mr. Bowsher, you've already said that your next report on the financial viability will be released in late August.

Please describe—I'd like Mr. Craren also to describe—in as much detail as you can——

Mr. BOWSHER. We can describe the report.

Senator CRANSTON. What will be the major components, and what information will be included?

Mr. BOWSHER. Yes. What we would include in the 1988 financial audit report would be a set of financial statements and the auditors would have reviewed not only the balance sheet, but also what happened during the year.

So, in other words, all the financial statements would have had an auditor's review. Then, in addition to that, you would get a separate report on the status of internal controls, and a separate report on the compliance of laws and regulations, and a management letter indicating areas that the auditor feels that the HUD management should take action on making improvements.

Then, of course, we will have the program audit work that Johnny is doing as a separate report, so you will have all of that in September if everything goes according to schedule, which we hope.

Senator CRANSTON. What questions do you feel the report will help us answer as we conduct this series of oversight hearings? And how will your work help identify and resolve problems at FHA?

Mr. BOWSHER. I think the report will give you an indication at the end of 1988 as to what is the financial position of these four funds. Where are the problem situations? What are the problems that happened in 1988? What are the control problems?

And I think the control problems are going to be absolutely crucial in trying to get on top of these problems. And I think that you will have the basis, and this is what I'm going to tell Secretary Kemp, you will have the basis for coming up with a management plan for the next 3 or 4 years of getting HUD in good shape, get-

ting on top of the controls, getting the information flowing properly.

And that's what I think you'll have as a result of these reports in September.

Senator CRANSTON. Any comments?

Mr. CRAREN. No. I would just agree and say that I think the reports will provide a better breakdown and a better idea of how FHA really runs; or what its subsidized activities are and what its self-supporting activities are.

Senator CRANSTON. One final question.

Does the nature of your survey—I guess I do have one more question after this, but I would like to ask you:

Does the nature of your work and the judgments you are able to make enable you to shed any light on this issue that has arisen as to whether the downpayment problem relates to the viability of the fund?

Do you have any views on what we should do on the downpayment front in the legislation that we are considering, that Al D'Amato and I have put together?

Mr. BOWSHER. I think the work that Mr. Ols is doing will help us answer those questions. We don't have those answers today, but we'll have them in September, hopefully.

Senator CRANSTON. Have them when?

Mr. BOWSHER. In September, when you come back from recess.

Mr. OLS. And we will be listening to the Senator's comments about the sliding scale and holding the downpayments the same. And we're going to compute various economic analyses of whether or not raising or lowering the downpayments with either pay now or pay later, with that change in policy.

And we're going to look at that from various angles. We hope to come up with various options you can consider as part of your legislative package.

Senator CRANSTON. I think that completes the questions that I have this morning. There are probably some others I should ask.

Mr. BOWSHER. We'll be pleased at any time your staff wants to send additional questions over during the month of August; we'll try to include that in our work.

Senator CRANSTON. Fine. We will be having another hearing tomorrow at 9 a.m. with a number of witnesses before us, and another one Thursday with Austin Fitts.

I want to thank Austin Fitts for staying through this hearing and demonstrating her great interest in what we're doing. I hope that will help her, as she has the responsibility.

Thank you very much for helping us carry on this work.

[Whereupon, at 11:35 a.m., the subcommittee adjourned, to reconvene at 9 a.m., Wednesday, August 2, 1989.]

# ASSESSING RECENTLY REVEALED PROBLEMS IN FHA AND GINNIE MAE

THURSDAY, AUGUST 3, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS,
*Washington, DC.*

The subcommittee met at 10 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Alan Cranston (chairman of the subcommittee) presiding.

Present: Senators Cranston, D'Amato, and Pressler.

## OPENING STATEMENT OF SENATOR CRANSTON

Senator CRANSTON. Good morning. This hearing will come to order. I welcome all of you.

This is the second in an important series of hearings that will assess the ability of the Nation's leading housing finance agencies to serve America's home buyers today and in the future.

Today's hearings will continue the subcommittee's review of the management and financial soundness of the Federal Housing Administration.

Subsequent hearings will assess the financial condition of the Government National Mortgage Association or Ginnie Mae.

Later in September, a related set of hearings will assess the long-term stability of the capital requirements in the public purpose of the Nation's principal secondary mortgage market institutions, Fannie Mae and Freddie Mac.

We begin this set of hearings by concentrating on FHA. Recent news reports have carried disturbing claims that FHA reserves have fallen significantly in recent years because of mismanagement, fraud and abuse, and the continuing economic slump in the southwest.

Our hearings will seek a full and objective assessment of the financial condition of FHA. We will investigate the full extent of problems of FHA and assess the long-term effect of these problems on the future strength of the FHA fund.

We will determine what can be done to stem the losses and guarantee that FHA will remain sound for the long-term. I intend to work closely with Secretary Kemp and my colleagues in the Congress for enactment of any legislative solutions that are needed to make FHA a strong and responsive institution that is able to serve the housing needs of future generations in all parts of this country

as magnificently as it served the needs of the American people years ago.

The subcommittee is now refining the Cranston-D'Amato National Affordable Housing Act, intended to expand the scope of the legislation and strengthen the provisions that are related to FHA.

Some have expressed a worry that the unfolding scandal about HUD under the Reagan administration has somehow slowed down action on this vital legislation, or even placed the bill on the sidetrack.

Let me put that worry to rest. The Cranston-D'Amato bill is the highest priority of this subcommittee, and it is on a very fast track to enactment. That bill provides the single best legislative vehicle for opportunities to clean up the mess at HUD left by the Reagan administration, and to initiate a much more effective National Housing Policy for the future.

Work on the Cranston-D'Amato bill gives the country an enormous headstart in correcting the causes of that scandal.

A key thrust of the bill would get HUD out of the business of making funding awards to individual projects, which is the principal cause of the Reagan administration scandal. Work on the Cranston-D'Amato bill gives the country an enormous headstart in helping to provide decent, affordable housing for all Americans, as well as to make the most efficient use of scarce resources.

When the National Affordable Housing Act is enacted, it will be the reform legislation that restructures HUD for the future. There's good reason for that. All of us who participated in the development of this legislation over the past 2 years and more, and that includes a large number of the country's housing leaders, knew the country needed an ambitious bill.

Of course, we did not know of the misdeeds of individuals and the problems at FHA and HUD. But we knew that, during the Reagan years, HUD was badly weakened, demoralized and in need of thorough-going reform.

For that reason, the Cranston-D'Amato National Affordable Housing Act emerged as comprehensive reform legislation that would make a sweeping overhaul of HUD and Federal housing programs.

Now, the entire country is learning the extent of the Reagan administration's mismanagement and abuse of HUD. The unfolding scandal shows the extent to which the country's housing policy has been in the hands of its enemies.

The scandal reveals the cynicism and hypocrisy of those who were trying to destroy Federal support for housing. We must not let their corruption now be used as an excuse to complete their destructive mission.

I believe a powerful coalition of support for housing is growing in the country, and I believe Congress will respond to that need.

Markup on the Cranston-D'Amato bill will occur in the fall. I am confident that landmark housing legislation will be enacted during this Congress. Enactment of that legislation will be an achievement of both parties, an achievement of both Houses of Congress, and an achievement of both the Congress and the administration.

I'm increasingly encouraged by the ability of Secretary Kemp and the Congress to work together to achieve this vital new hous-

ing legislation. This morning's hearing is an important part of the process of cooperation.

I'm pleased to see Austin Fitts, the Assistant Secretary for Housing and FHA Commissioner, is able to appear before this committee this morning, in the full regalia now of her very important post. I congratulate you on your confirmation last night. I'm told that the committee received more calls in support of your nomination than any other nomination. A large number of people have confidence in your ability to do this extremely important job.

I look forward to working with you also, and I wish you well.

Your starting weeks at HUD have given you something like an insider's view of a fire storm. I hope the experience has only served to sharpen your senses and accelerate your learning about your new responsibilities.

Your entire testimony will be included in the record. Please proceed as you see fit with your testimony.

I want first to ask Senator Al D'Amato if he would like to speak.

Senator D'AMATO. Mr. Chairman, recognizing that those of us in the Senate have a penchant for speaking whenever given the opportunity, whenever having an audience of at least one, and not necessarily more than one, I would like at this time to add my congratulations to the confirmation of C. Austin Fitts. I think her unique talents and her abilities come at a time when they're certainly necessary and needed.

And I'd also like to commend the Secretary for the reform package that he submitted to us in five categories.

And I'm going to ask that the full text of my remarks could be placed in the record as if read in their entirety, so that we can hear from Ms. Fitts.

## STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, I am pleased to welcome our newly confirmed Assistant Secretary for Housing, C. Austin Fitts. Ms. Fitts testified before our subcommittee a couple of days ago. She exhibited a determination and candor that is vital to tackle some of the difficult problems at the Department of Housing and Urban Development.

This hearing will continue the subcommittee's assessment of the Federal Housing Administration (FHA). On Tuesday, the GAO summarized its financial audit of the FHA insurance funds. The testimony revealed that there are major information and data problems which must be overcome in order to monitor FHA on a regular, ongoing basis. In addition, the hearing raised a number of unresolved questions about the viability of the FHA funds. These questions will not be answered until GAO completes its second FHA audit which will look at the status of the funds up to the end of 1988. This second audit should be completed by September of this year. It is my assumption and hope that this subcommittee will hold hearings to focus on the findings of the audit.

In addition to the FHA hearing, Secretary Kemp introduced a new reform initiative, called "FHA for the 1990's", earlier this week. The Secretary is to be commended for recognizing the past problems of management and program structure and for setting

forth a strategy to turn around the evident fraud and abuse. I would like to assure the Secretary that Senator Cranston and I are eager to work with him in order to promote an efficient and worthy use of federal housing dollars.

The Secretary's reform package for FHA can be divided into 5 categories. The initiative is designed to reinvigorate FHA, to strengthen its finances, and, most importantly, to commit the agency to increasing the number of first-time homebuyers. Below is a list of the five areas of reform.

One, accounting improvements: HUD will publish annual audited financial statements, take steps to comply with the Federal managers integrity act, and implement recommendations made by Price Waterhouse. These reforms are intended to provide HUD with detailed and timely information to enable it to determine the actual financial status of the FHA funds.

Two, independent analysis of actuarial soundness: HUD will hire an independent "big eight" accounting firm to do a full analysis of the actuarial status of the MMI (single family mortgage insurance) and GI (insurance for specialized mortgage programs) funds.

Three, management accountability: Accounting and computer systems will be redirected to senior program leadership. This will ensure that senior leadership is accountable for losses associated with the FHA funds.

Four, lender reform and fraud prevention: HUD will review lender requirements so that only responsible and soundly capitalized lenders participate in FHA programs. In addition, HUD will increase its monitoring and enforcement activities.

Five, FHA task force: A task force of senior FHA and HUD officials is being created to oversee the soundness of FHA funds, recommend beneficial changes to the funds, and suggest ways to ensure that FHA is available to all parts of the country.

These reforms are a major step toward a stronger and healthier FHA program. Senator Cranston and I have been working on additional reforms, primarily aimed at ensuring that FHA assist first-time homebuyers. A number of these reforms have been discussed in studies and newspapers in the past few weeks. It is my hope that Assistant Secretary C. Austin Fitts will comment on some of these reforms today, particularly in reference to their impact on the homebuyer and on the long-term viability of the FHA fund.

Senator Cranston and I will be working on additional reforms which focus more on the fraud and abuse which have plagued HUD programs. I look forward to working with the Administration on a reform package.

Declining rates of homeownership are becoming a problem in many parts of the country today. In my own home State of New York, young working families have difficulty buying a home. It is my hope that with the administration, and with other members of Congress, we can assist these families, and we can provide assistance in a way that promotes the long-term stability of the FHA program.

Thank you, Mr. Chairman.

Senator CRANSTON. Austin, we welcome you.

**STATEMENT OF C. AUSTIN FITTS, ASSISTANT SECRETARY, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, WASHINGTON, DC, ACCOMPANIED BY PETER MONROE AND RUSSELL DAVIS**

Ms. FITTS. Mr. Chairman, thank you very much.

Senator D'Amato, thank you.

First, thank you for holding these hearings. I believe that they're critical to getting us to a good housing initiative. And I appreciate the time that you're willing to spend on what are in many cases obscure management issues, but absolutely critical to the issue of affordable housing in front of us.

I also on a personal note want to thank you for the confirmation. I'm very pleased now to be functioning in an official capacity. I thank you for that.

Before I begin, I want to introduce some of my table mates. One of the things that makes me most optimistic about what we can achieve together is really the extraordinary quality of the people throughout the agency that the Secretary has recruited.

With me today are two of them. To my right is Mr. Peter Monroe, who, hopefully, will soon be serving with us as the general manager of housing, FHA.

To my left is Mr. Russell Davis, who serves with me as a special assistant, who has done yeoman work in working to prepare me for some of the challenges ahead.

I have testimony for the record and we will submit it. I just want to make a few points so that we can get to your questions, and to something a little more specific.

We've said a lot and we've heard a lot in the testimony on Tuesday, and we've been reading a lot in the paper about what's wrong with FHA.

Before we begin, I'd just like to say one word about what's right with FHA. FHA, before I came here, was known in the capital markets as one of the great innovations, one of the great government success stories.

Annually, we help 600,000–900,000 people purchase single-family homes and do many other things. There are millions of Americans who live in homes helped to be financed with FHA.

I think that has been done with no cost to the American taxpayer. That is truly a great success story, and I think that is something to build from.

I'd like to make a couple of key points both from the initiative that the Secretary announced on the FHA—excuse me, there are three points I'd like to make.

One has to do with the importance of disclosure.

The second has to do with the losses and what they mean that we've incurred and will incur in fiscal year 1988.

And, finally, I just would like to say a few words about the kind of base we have to build off of.

First, I know that whenever you talk in many circles about the importance of independently audited financial statements, most of the people I know start to yawn and go to sleep. But I want to make one point about those statements.

I was so glad to hear GAO say what they said. I was also glad to see that it was a commitment that the Secretary has made 2 weeks ago. I know, when the Secretary was testifying in front of some of the committees on the Hill about what has happened, many people kept saying:

"Well, all of these reports by the Inspectors General were delivered to Congress. Why is it that the press didn't notice? Why is it that people didn't notice?"

Certainly, I think that's a good question, but what ought to be appreciated by many of the people who are looking at what happened was that it's very hard when you receive documents this thick for everybody, particularly very busy Senators and their staffs and Congressmen and their staffs, to read all of this very technical information.

Senator CRANSTON. I suppose this is the point that we should both yawn and fall asleep.

Ms. FITTS. The advantage of accounting statements and well-prepared accounting statements is that they all come down to one or two little numbers that are very simple and easy to read for the press and for many people.

And I think if we had had those one or two simple numbers well-prepared all the way along, they would have served as a far more effective flag, a red flag, to put people on notice.

So, even though it sounds like a very boring topic, the importance and the value of that tool going forward in a financial operation like this cannot be emphasized enough. I just want to point that out.

Second of all, GAO——

Senator CRANSTON. Secretary Kemp did indicate yesterday that he's going to do annual audits.

Ms. FITTS. Yes, sir. The Secretary committed in his testimony in front of the two committees over in the House who have been holding hearings, and, again, in his "FHA for the 1990's" initiative, that from this point on we would have independent annual audits in accordance with generally accepted accounting principles.

That's a firm commitment.

Second, there was some talk on Tuesday as to the fact that we would be taking losses in fiscal year 1988. It's been a topic of interest as to how much losses we would take on certain things. I just want to make a few comments there.

First of all, I was glad to hear GAO say that this was not FSLIC. Certainly, it is not FSLIC, and not just because of the size. But I think it's important to recognize two things.

One, this is a situation that involves no interest rate risk, as was contributory in FSLIC's difficulties. But, more important, the credit that stands behind FHA is a very different kind of credit. It's the credit of millions of American taxpayers and workers across this country.

I said millions of Americans live in homes because of FHA. Senator D'Amato talked about the firemen and the workers. That's the credit that stands behind this institution. And I think there's no better credit; it's the future of America.

So I commend the credit to you. It's a credit that is ongoing. It's a need that's ongoing.

Another thing I think is very important to recognize as we go through these hearings, and as we go through designing the future, the difference in the different funds.

The MMI Fund has one purpose, and it's a very different kind of program than the General Insurance Fund. I think this is important because the General Insurance Fund and the Special Risk Insurance Fund were set up to do programs that were risky.

I would hate to see the results of what has happened in the last 4 years to be that we would come to the conclusion that we should not take risks and we should not take losses because the purpose of FHA is not to make a profit. It has a very important social purpose and there are some risky programs and there are some speculative programs that we ought to be doing.

What I would submit to you, what I've been advising the Secretary is that we took those risks possibly for the wrong reasons, but there are right reasons to take those kinds of risks.

And I think what we've got to do is redirect our risk-taking capacity to them. I think that your legislation certainly recognizes a lot of that.

But I would hate for us to leave this thinking that losses are bad and that we would have to run this exactly like a business. This is not a business, but our goals are those of social purpose.

The last thing. Many are the people in the last couple of months who have said to me: "Oh, this is terrible. How can you possibly achieve the Secretary's objectives in the next 4 years?"

I want to point out there has been some very good work done. GAO's testimony, and they are to be complimented, they have done 2 years of hard work, gives us a strong base to work off of.

There is a second thing I want to make clear. Many people told me when I came here that all the good people at HUD had left. That is absolutely not true. We have 13,000 employees at HUD, in the headquarters building and our regional offices. And the operation is filled with dedicated public servants who achieved enormous things in the last 4 years.

And I would hate for their service and their accomplishments not to be recognized. It's the strength of those middle managers that we have to work off of.

And, finally, in case you didn't think I was complimentary enough on Tuesday of the work that this subcommittee has done, I think probably the thing that makes me most optimistic is to see the work that you have done on gathering not only the terrific ideas on housing, but really a marvelous coalition of groups who, in my experience, oftentimes don't agree but squabble.

I think that the Cranston-D'Amato legislation gives us a huge basis of work in good things and coalitions to work from. And, in fact, in determining whether or not I felt that I could accomplish anything in this job, it was your work filled with excellent and meaty stuff that made me think that a tremendous amount could be accomplished.

I commend you on that, again. And I commend you on those hearings.

I know you want to get to questions, so let's go.

Thank you.

[The complete prepared statement of C. Austin Fitts follows:]

STATEMENT OF C. AUSTIN FITTS,
ASSISTANT SECRETARY FOR HOUSING/FEDERAL HOUSING COMMISSIONER,
U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

BEFORE THE
SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
UNITED STATES SENATE

AUGUST 3, 1989

Mr. Chairman, Senator D'Amato and members of the Subcommittee, I would like to thank you for inviting me to be a part of your hearings on ways to improve the Federal Housing Administration. Secretary Kemp and I share your belief that a vigorous and responsive FHA will be vital as a foundation on which to build future housing programs. We view these hearings as a very constructive effort. Your willingness to devote attention to what some consider to be obscure management issues is critical to the formation of an effective national housing policy.

In particular, Chairman Cranston and Senator D'Amato, your comprehensive housing legislation impresses me with its broad scope and creativity. Especially noteworthy to these hearings is that the proposed Cranston-D'Amato National Affordable Housing Act includes many strong proposals to expand homeownership opportunities for first-time homebuyers through FHA. While details will no doubt be debated, the bill has appropriately identified the critical issues for first-time homebuyers: mortgage availability and the downpayment. These issues must be addressed in connection with the growing concerns over the continued financial health of the FHA Funds. Secretary Kemp and I look forward to working closely with the Congress in the coming months to move quickly toward the goal of increased homeownership opportunity.

On a personal note, I would like to thank the members of the Banking Committee, particularly Chairman Riegle and you Chairman Cranston, for the prompt action on my confirmation over the past two days. I appreciate that an extraordinary load of events is weighing upon you at this time. Secretary Kemp has also asked me to convey to you his personal gratitude.

Bush Administration Commitment to FHA

To begin with I wish to assure the members of the Subcommittee that the Bush Administration is committed to FHA. As the critical foundation of our national housing efforts, FHA has a historic mission to fulfill: to provide mortgage credit in those areas and to those families which are not adequately served by the conventional mortgage market.

President Bush and Secretary Kemp have established six priorities for the Department of Housing and Urban Development. The first of these is enhancing homeownership and affordable housing opportunities. Every year FHA insures mortgages for 600,000 to 900,000 additional families for the purchase of their homes. In 1988, approximately 450,000 of these families used FHA to realize for the first time their dream of homeownership. Today over nine

million American families live in FHA-insured homes. To date, this homeownership success has been accomplished at no cost to the taxpayer. We are committed to seeing this success story continue.

Our goal is to eliminate problems, not programs. As the Secretary stated in his letter to Chairman Cranston two days ago, "It is absolutely essential that our objective of serving the poor, and expanding opportunities for young families to purchase their own homes, be coupled with responsible financial management and sound business practices."

Secretary Kemp insists that his commitment to FHA be held throughout HUD. His first "FHA reform" action was absolutely the most crucial - and it required no legislation or rulemaking. He simply demanded that his top appointees at FHA pledge to remain for the duration of President Bush's first term. For an agency which had seven FHA Commissioners in the last eight years - and corresponding chaos in the lower appointed positions - the cleanup will require four years of close and continuous teamwork.

Role of FHA in National Housing Policy

Historically, FHA has been crucial in three areas. I believe that these functions will be especially critical to the new housing approaches being developed for the 1990's.

First, FHA has been an innovator and standard-maker in the mortgage markets since its inception. During the Depression it established the 30-year amortizing mortgage as the basic model for home lending. As such a market leader, FHA has been at the forefront in the development of innovative mortgage financing techniques necessitated by changing market conditions. Products developed by FHA have been adapted by the private sector and made available to an even wider marketplace. We believe, as we know the Subcommittee does, that it is essential that FHA be given the flexibility to design products that enable it to serve all of its markets effectively and efficiently.

FHA now provides a wide variety of programs to meet the needs of a similarly wide variety of housing needs. The agency serves middle, moderate, and low income families; it helps to finance condominiums, manufactured homes, and home improvements in communities across the nation.

Secondly, FHA has filled the gap at times and in places when the private sector was not adequately serving home lending needs, and in the process it has become a cornerstone of the government's policy to meet the nation's mortgage requirements. We plan for FHA to continue to serve that function.

Our goal must be to target actively those markets which are presently underserved by both the private sector and FHA. For example, many inner city areas are underserved because neither FHA

nor private insurers have developed the specialized distribution systems and methods to serve these areas at reasonable cost. We need to work more closely with community based lenders, local agencies and nonprofits to "greenline" those communities that have not had adequate access to mortgage credit.

Finally, FHA has been a critical part of the nation's low-income housing infrastructure. Thousands of "assisted" housing projects include a component of FHA insurance as an integral part of the financing. This role will be particularly critical to future methods of low and moderate-income housing finance, which will depend heavily on multiple funding sources and multiple partnerships of government and private interests. A party willing to assume all or a portion of the long-term credit risk is essential for raising all participants to the necessary comfort level.

Because both the Bush Administration's approach and the Cranston-D'Amato proposal will emphasize innovative, decentralized financial partnerships with state and local agencies, non-profits and the private sector, a strong FHA is essential. Future housing legislation must therefore assure the viability and usefulness of FHA by addressing some of the causes of current problems and potential problems in the future.

FHA's Current Condition

We have no reason to believe that the Mutual Mortgage Insurance Fund is not actuarially sound. Secretary Kemp and I feel it is necessary, however, to undertake our own comprehensive evaluation of FHA's portfolio. The status of the Funds can change rapidly with fluctuations in the economy and variations in the composition of the portfolio over time. To fully understand and be prepared to deal with these effects we have requested an independent actuarial study of the Funds. As explained further below, our greater concern is not for our current portfolio alone, but for the long-term structural soundness of the Funds in the future.

The General Insurance Fund differs from the Mutual Mortgage Insurance Fund in that it is not required to be run strictly on a breakeven basis. This Fund has been particularly hard hit by losses in the coinsurance program. An independent actuarial review will be performed on these programs also, so that we make help make this fund financially strong as well.

In general, many of FHA's current problems can be attributed to poor management at HUD; these are problems that can be corrected. Far greater business problems in the future, however, will be the result of statutory constraints. We must decide together which are HUD's responsibility to correct, and which are jointly the responsibility of Congress and the Administration. While HUD action will often be sufficient action in the short run, legislation may be necessary to ensure that these practices endure beyond the tenure of the current Administration.

After four months of internal review, we have a much better understanding of the causes of FHA's recent management problems. Secretary Kemp's letter of August 1, 1989 to this Subcommittee described his assessment of FHA's condition and his "FHA for the '90s" initiative. Many of the key points and recommendations of this initiative were independently put forward by the General Accounting office in its testimony to this Subcommittee. We would like to compliment GAO for some very insightful and constructive comments, which are the result of two years of hard work, which has made our jobs much easier.

Secretary Kemp's Reform Plan: "FHA For The '90s"

Secretary Kemp's "FHA for the '90s" initiative is a wide-ranging effort to reinvigorate FHA, to strengthen its finances and, most importantly, to commit the agency to increasing the number of first-time homebuyers.

1. Accounting Improvements. FHA management has not had detailed and timely information to enable it to determine the actual financial status of the funds on a timely basis. This seriously undermines FHA's ability to make decisions on the long-term financial strength of the funds. Without timely recognition of losses, programs can run for years before cash losses bring attention to the problem.

Reform Actions:

- o HUD will publish annual audited financial statements which will present FHA's financial condition on an accrual basis that is fully consistent with Generally Accepted Accounting Principles (GAAP). These statements will complement the continued reporting of results on a cash basis for budgetary purposes.
- o FHA will revise its revenue recognition formula to prevent overpayments of premium refunds.
- o FHA will take steps to comply with recommendations to be made by Price Waterhouse in its Management Letter to be delivered in connection with preparation of FHA's FY 1988 Statement of Financial Position.
- o The General Counsel of HUD and the Assistant Secretary for Housing/FHA Commissioner will review and report on steps necessary to ensure full HUD compliance with the Federal Managers Financial Integrity Act.

2. Independent Analysis of Actuarial Soundness. Although simplified projections have been made of the economic vulnerability of FHA, no independent actuarial analysis of FHA's portfolio itself has been undertaken on a program-by-program basis.

Reform Actions:

- o HUD will hire an independent "big eight" accounting firm to do a full analysis of the actuarial status of the MMI and GI Funds. This study will test FHA's portfolios for structural weaknesses, point out what it feels are unsound underwriting criteria, evaluate the impact on the Funds of a variety of policy terms and conditions, and develop a computer model which FHA actuaries can use to test the financial impact of changes to FHA programs over time.
- o Also reviewed will be technological and other related improvements which could (i) improve FHA efficiency, (ii) increase the distribution and marketability of FHA programs, and (iii) ensure the actuarial soundness of the portfolio in the future.
- o Over the next year FHA will hire additional actuaries for its staff.

3. Management Accountability. Within FHA there are no managers who are accountable to a "bottom line". In such a culture, losses are either not noticed or ignored. It is important that the support systems be geared towards the needs of the overall "bottom line" of the program manager.

Reform Actions:

- o FHA accounting and computer systems will be redirected to be accountable to senior program leadership, and these managers will be held accountable for both the responsible management of their programs and the timely and accurate reporting of financial conditions.

- o HUD will investigate the feasibility of an FHA Review Board composed of leaders from government, private industry, and academia who have expertise in matters affecting FHA. This Board would advise FHA and help protect the long term viability of its programs.

4. Lender Reform and Fraud Prevention. The majority of FHA's insurance is distributed by third parties in the public and private sectors. HUD has mismanaged this process such that lenders view this delegated authority as a right instead of a privilege, and HUD has failed in its efforts to firmly monitor and control lender activities.

Reform Actions:

- o FHA will review lender requirements to ensure that only responsible and soundly capitalized firms participate in FHA programs.
- o In addition, FHA will step up its monitoring and enforcement activities and take steps to contract with major accounting/auditing firms to expand the scope of our monitoring.

5. FHA Task Force. A task force of senior FHA and HUD officials is being created under the direction of the Assistant Secretary for Housing/Federal Housing Commissioner. This task force will study and report on the actuarial soundness of the agency's insurance funds, recommend managerial and technological changes necessary to protect the financial integrity of the funds, and recommend ways to better target FHA's programs to segments of the population and areas that are presently underserved.

Nature of the Long-Term Strategic Problems Facing FHA

Even with the best management, FHA could find itself in trouble in the coming years. To a large degree, these problems are the joint responsibility of HUD and Congress.

1. Need For Portfolio Diversification. FHA has depended for fifty years on nationwide diversification. To achieve the Congressional intent of self-sufficiency, such diversification is essential. But certain statutory constraints - mortgage limits and caps on FHA insurance premiums that preclude adequate risk differentiation being the most controversial - are increasingly squeezing FHA out of the strong housing markets at the same time that private mortgage insurers are abandoning weak markets to the agency. Such conditions may create a portfolio which is increasingly sensitive to inflation and recession.

2. Need For Technological Modernization. FHA must keep up with the rapidly evolving financial markets and the potential for efficiencies in the use of computers. An example of the value of such efforts would be the increased scope and efficiency of monitoring possible in delegated programs.

3. Need For Statutory Flexibility. FHA can maintain an actuarially sound portfolio by varying the mix of three variables: underwriting criteria, premiums, and portfolio diversity. While at one time the American economy changed slowly enough that actual numbers could be written into statute to govern these variables, that time is past. Instantaneous communications and computer technology make it possible for FHA's underwriting standards to become fundamentally unbalanced overnight, and we hope Congress will be willing to work

with us to remove artificial and unnecessary impediments to FHA's flexibility.

4. Need For Proper Balance of Actuarial Soundness and Subsidy."
Many FHA programs are intended by Congress to be run on a self-supporting basis. While we are sympathetic to the goals of those who wish to obtain portions of FHA's inventory of foreclosed multifamily properties, we must stress that the timely disposition of such property at the best possible price is essential to stemming losses to the Insurance Funds. That in turn is critical to ensuring the continued availability of FHA insurance without substantial losses.

Closing Comments

Mr. Chairman, ensuring the soundness and continued success of FHA is a principal objective of this Department of Housing and Urban Development. Achieving this objective will require the mutual efforts of the Administration and Congress. Secretary Kemp has already begun a strong reform effort at FHA, and we look forward to working with you to take those steps which will truly establish an "FHA for the '90s". I thank you again for inviting me to testify and I will be happy to answer any questions you may have.

Senator CRANSTON. Thank you very much for that fine statement. It's nice to have it not read but showing a grasp of the situation.

And we deeply appreciate your recognition of our efforts, our common efforts. I think we will achieve something.

Let's start with some general questions about some of the basic insights that you bring to your new office.

Let me state at the outset that the subcommittee knows very well that the GAO and Price Waterhouse efforts are still underway with major audits of FHA.

Their report won't be available for a few weeks. We understand you don't yet have the results. We know that, in a few weeks, we'll have new information and better information that will deepen your understanding of FHA and may require you to revise some of your opinions.

We'll be refining and revising our own views and the like. But I urge you to be as forthright as you can this morning, and I know you will be, in sharing your current views on the condition of FHA, and your plans for improving its future.

In your view, what are the basic purposes of FHA?

Who are the major constituencies that FHA should serve? And how well do you think FHA has been serving them in recent years?

Ms. FITTS. That's a big question. I think it's very important. Again, I mention this a little bit to understand that there are many different programs and many different purposes.

I think, at one point, Russ tried to count how many insurance products we had in the FHA, and it was moving up toward the number of [80].

### MMI AND GENERAL FUNDS

Let's talk first about the MMI Fund. The MMI Fund is our basic single-family homeownership fund. We see the purpose of the MMI fund as providing us with a major tool, a financial mechanism of providing affordable housing in the country.

It's really to a broad constituency across the country of low, moderate and middle-income families. That's the MMI fund.

In the General Fund, we have a wide variety of programs, many of which—some of which—are market rate programs to provide liquidity in similar ways, like coinsurance to multifamily, the rental market. Others are designed to target particular groups.

One of the things that I think is true about the MMI fund and the way the products in it are distributed is that it doesn't reach many of the groups that I think we would all like to help, particularly in the lower income areas.

The importance of some of the programs in the General Fund, the ones currently that we would like to see planned, and I think some of your conversation, is that we need to do a better job to target our financial tools to help those groups, the most needed.

So I see the FHA as having an extraordinarily broad constituency, and if I had to say it in one line, the purpose of all of this together is to provide as much liquidity as we can to the housing markets, to many groups across the country to help them do what

they do best. To make sure that the housing stock is as thriving as possible. But within each program, it's very, very different.

Senator CRANSTON. What do you believe should be the role of FHA in the country's home mortgage finance system over the course of the years? What are the greatest challenges to FHA to serve that role?

ROLE OF FHA

Ms. FITTS. I would go back again. I can't stress enough the importance of providing liquidity in a market where other parties, whether they be the private sector or State and local governments, can't do it without that broad based credit support.

A couple of comments on the problem at FHA. Yes, we've had losses. Yes, there has been mismanagement. The bigger problem is that we need to adjust to changing markets.

There has been in this country in the last 5 years, 10 years, a huge financial revolution—not just in terms of what has happened in the capital markets, but what has happened in terms of the technology that services those markets.

If we don't redesign our technological capabilities within the administration, and if we don't design our products in such a way as to capture the way those things are being done, we will not be able to reach the very groups that we want to.

Let me give you an example that I know you will support because I'm taking it from you.

One of the visionary ideas in the Cranston-D'Amato legislation is the concept of very flexible guarantees with State and local governments.

Let me go back and make a criticism of the way the FHA operates now. Right now, the majority of our insurance is distributed through the private sector: Single-family insurance through mortgage bankers. They do a very good, very effective job. Their job, of course, in order to survive is to make a profit. Therefore, they have very little incentive, nor can they or are they organized to reach to certain groups, as the manner in which housing is delivered in this country changes to one which requires tremendous partnerships between private, public, State and local, Federal. And you require much more complicated things going on at the State and local government. It's very important that we find alternative delivery systems to provide and help financing at those levels.

The kind of guarantees that you envision in Cranston-D'Amato would permit us those techniques. We really don't have them now. It would give us flexible pooled insurance that could be done directly with State and local governments.

That would give us the ability not just to serve those markets that the mortgage bankers acting on their own would automatically go to, but instead to target specific areas with very responsible partners in a way that, compared to, I think, some of the programs we have, should not have to be risky and can be done on a very prudent basis.

These things are required because of the changes in the housing markets and the capital markets. So we need to change the way we do business simply to serve and reach those constituencies.

And the most important thing we face is to make sure that we have the tools to do that.

Senator CRANSTON. FHA is comprised of several quite different insurance funds—the Mutual Mortgage Insurance Fund, the General Insurance Fund, the Cooperative Management Housing Insurance Fund, and a Special Risk Insurance Fund.

Each one has a different purpose. Each is intended to operate with somewhat different loss experiences.

Which funds have historically required congressional appropriations which have the most significant losses and what, in your view, have been the major developments that will affect the performance of each of those funds?

Ms. FITTS. Let me focus on what are the two most active funds right now. They are the MMI Fund and the General Fund. The MMI Fund was conceived of to be self-supporting and, in fact, it still is; although we have been experiencing losses in recent years, our reserves continue to be far in excess of our accumulated losses.

In our opinion, there is no reason why, and it will take some work to assure this, that the MMI Fund should not continue to serve its purpose on a self-supporting basis.

The General Fund is very different. The purpose of the General Fund is to enable us to separate risks and to not endanger the MMI Fund; to do separately a lot of different programs, particularly on the multifamily side, that entail more risk.

Within that fund, there are many programs, some of which are done at market rate. Many of our multifamily programs are not highly targeted, for example, to low income. Those programs, even though they're in the General Fund, should be done in a way that does not incur substantial losses. They should be done on a self-supporting or near self-supporting basis.

There are other ones clearly that should not be.

One of the important things to accomplish at HUD in the next 4 years is to define within those programs what loss experience is tolerable from a social standpoint. And by that, I mean that the costs clearly justify the benefits. And to then determine how those programs will be run.

Now, the General Fund has drawn on Treasury appropriations. It is financed. To the extent there are losses, it is financed by the Treasury. And it has taken losses in recent years.

Senator CRANSTON. As you know, we've had a stream of outrageous stories about the insurance funds recently. None is more bizarre than Robin HUD, the FHA manager who stole $5.5 million in HUD funds and gave much of it to her favorite charities.

Frankly, I can't understand how she was able to embezzle that amount of money over 2 years without anyone noticing. The news media reported stories of incredible cash management practices, large checks lying around in desk drawers—often for weeks—in area offices.

It seems to me as a basic matter that key managers at a complex operation like FHA, from the area office up to the Assistant Secretary, would have control over the program of financial activities for which they're responsible. I expect they would have control over basic information and be held accountable.

And I would expect the managers would very quickly see that funds were missing and act promptly to put a stop to that situation.

Yet, Secretary Kemp said:

"Within FHA, there are no managers who are accountable to a bottom line." Unquote.

That seems to be a flaw that needs to be corrected very swiftly. As someone with extensive experience with complex financial organizations in the private and public sectors both, what's your opinion on what could have let this situation develop?

Is this an example of incompetence or corruption of individual FHA employees? Or is there something more structural and systemic at work here?

And what is it about the management of the FHA programs that would permit this to happen?

Ms. FITTS. That's a very good question because I know when we first uncovered this, we had 20 people at the table screaming: How could this happen?

This is a good example, and there are many other good examples—of which coinsurance is one—but many others. When FHA was first moved into HUD, when HUD was formed almost 25 years ago, a decision was made to move many of what had been the FHA functions into other departments.

For example, all of the accounting and the financial systems were almost all removed separately to a Department of Administration that served all of the departments.

This has had a very important impact and I have to differentiate now between the difference between grant operations and financial operations. By financial operations, I mean operations where one is taking risk and creating a contingent liability like insurance. In a grant operation, a dollar is put out and it's recorded. It's fairly easy to track and measure.

In a financial operation, someone makes a decision to take a risk. That risk is with us for anywhere from 1 to 30 or 40 years. In that situation, if the person underwriting—taking the risk—doesn't constantly track how that risk looks, what the financial ramifications of that risk are, they stop having the critical information they need to assess whether they're doing the right thing.

### THE CASE OF ROBIN HUD

Now, let me go back to the specific case in point. In Robin HUD, you had two different groups involved in the performance of the property disposition operation. On the one hand, you had the people, whether it be in the field or headquarters, running the inventories, arranging the closing agents, making sure the logistics of selling houses were being followed.

On the other hand, you had a group of people responsible to make sure that the cash got to the U.S. Treasury, to make sure that all of the numbers were added up.

You had two totally separate groups, one responsible for program performance, one responsible for the financial reporting of the programs.

Literally, the two in some instances did not communicate or had trouble. They were too far away.

As that happened, a culture has developed whereby program managers who are responsible either for the houses getting sold, or for underwriting decisions on insurance to be made, stopped feeling, stopped realizing, stopped thinking that the financial results were their problem. They stopped thinking that they were accountable.

And this kind of very unfortunate breakdown in communications led to a situation where neither manager could really test reality; whereas, our program manager over here knew how many houses were going in and out of inventory, they could never check that against the numbers, and vice-versa.

So there was no one person who would be accountable to make sure that the inventory made sense against the money coming in the door.

That is one of the critical things we must fix at the agency if we're going to go forward because, and this is what's most important, as I said earlier, there has been a financial revolution in this country and a revolution of technology. That means that real estate markets and capital markets move much faster.

And it is so important that when we take risks we know moment to moment what that risk looks like. If we had been able to know, as for example I'm sure everyone is familiar, that we had several coinsurers who were taking substantial losses, if we had been able to know every minute, or at least every quarter how much money they were losing, it would have been much harder for employees in the organization to justify their actions in support of those coinsurers.

So this kind of accountability, not just in a program but combined with financial accountability, is absolutely critical.

Senator CRANSTON. Thank you very much for a very concise answer to that question.

Al, I've used about 15 minutes. Why don't you proceed with your questions?

Senator D'AMATO. Thank you, Mr. Chairman.

I didn't intend to go into this, but could you expand a little more, Ms. Fitts, about what is a DRG. And I guess you're still in the process of attempting to assess just what the losses are. What they would be?

It would seem to me that, if you had a system of risk assessment or quarterly reports following this, that at some point you would have stepped in.

Ms. FITTS. That's so.

Senator D'AMATO. Is that where we're getting?

Ms. FITTS. There are two things that are important to recognize, one of which GAO brought up. There are two issues: one is managerial accountability, and the other is regular reporting. Let's take the person in charge within the multifamily operations under FHA.

There is a manager who is in charge of the coinsurance department. If that manager were responsible for the financial performance of the program, not just the growth of the program or the number of coinsurers, or the number of units we were financing,

but also for the financial performance, the decisions and the recommendations made by that manager would be very different than if that manager is thinking only about creating more units or only about adding coinsurers to the program. They're going to think a little bit differently than if they also have to report to me or to someone else as to, well, why are we losing so much money?

What happened was those two accountabilities got split apart.

The other thing, and GAO I think did a very good job of making this clear, is the importance of looking at your financial performance not just on a cash basis, but on an accrual basis. On a cash basis, many of our losses on DRG will not occur until, for example, the 1991 budget on a cash basis.

If we had been looking at it on an accrual basis, 1986, 1987, 1988, those losses would have been very, very clear. And it would have been much harder for anyone in the agency, particularly with disclosure coming to this body, to justify the actions of continuing to permit that particular company in the program.

So it's two things. It's the accountability, the financial accounting, surrounding the underwriting process. But it's also the importance of looking at financial performance on both a cash and an accrual basis and reporting it. And not just to me or the Secretary, but reporting it with annual financial statements that go fully to this body, to the press and to the world.

Senator D'AMATO. Are you in a position—I don't mean to be unfair—to make an assessment as to some of the kinds of things that went wrong with DRG, in particular? Or is that beyond your ability to focus on at this time?

Ms. FITTS. In a way, it's a little bit hard for me to be specific on that issue because the day I came to work for the Secretary, he basically said, "Go through this organization as quickly as you can and figure out what we have to do to stop losing money, or stop doing irresponsible things, or stop doing corrupt things—as quickly as possible."

And my focus on coinsurance has been particularly what do we have to do to fix it, as opposed to what exactly happened.

You have to look at what happened to design a program to make sure it works in the future. The key issue that happened with DRG—there are a couple, but let me just focus on two—the most important thing, or one of the most important things, when you are dealing with very flexible and powerful financial tools—and this is a question that's going to be with us more and more in the future—is that you really have to know who you're dealing with.

You have to ensure the quality of the people to whom you are delegating responsibility. In that instance, if someone is not fulfilling their responsibilities—and I would submit to you that DRG was not—it's extremely important to get them out of the program.

I think certainly the biggest mistake was made when it became clear that it was time for them to be suspended. But that was not done.

There is another thing though. And that is it's very important again to always be tracking the costs of not just a program but of a participant. We should always be looking at what the income is of a participant, what the losses are, what the claims recovery is—in essence, the bottom line.

If somebody had been measuring again regularly what the bottom line was, not just of the program but each participant, they would have made much better judgments about who's in and who's out. But you have to have the will to drop a bad participant.

Senator D'AMATO. You mentioned in your testimony the need to have tools to go after the targeted, underserved market, if I'm quoting you correctly, with FHA.

What tools are you referring to, if you've come to any decisions, and will this require legislation to give you those tools?

THE NEED FOR LEGISLATION

Ms. FITTS. Absolutely. We have some programs that can do it, but to try and do it with them would be very slow and cumbersome. And, yes, I do think legislation is needed. I think probably by far the finest tools are the guarantees envisioned by your legislation, what I would call pooled insurance. And that is to be able to do flexible pooled insurance with State and local governments on a wide variety of low and moderate housing, whether it be single-family or multifamily.

I think that was what was envisioned by those tools in Cranston-D'Amato. Those tools would be critical and extremely useful.

Senator D'AMATO. Let me, if I might, come to the question that I indicated I would ask you and so I would expect that you have more than ample facts or will be developing them as it relates to FHA insurance, about raising the limit in the high cost areas so that it would afford an opportunity, particularly for first time home buyers, to participate in FHA.

It's a question of social policy. Should we seek to increase participation from working families who are first time home buyers? Should we say: If we fail to raise the FHA limit, (which is what? I think, $101,000 or thereabouts) are we taking a policy position that FHA will not participate in high-cost areas as it relates to buying the purchase of one-family homes?

I'd like your analysis of that. Some have written editorially, the Times, the Journal, and others. And I might say that I would suspect, with regards to our bill, which lowers downpayment requirements, that there may be indeed evidence that would indicate that that would create a more vulnerable situation both for the FHA program and for the home buyer.

I can see that argument, but I am concerned about whether or not we should be raising it. Will we be bringing in more revenue? Will we make the program—give it a broader base, make it stronger? Should it be our objective to get that first-time home buyer in these high-cost areas that opportunity?

We're not all in the oil patch area. And, by the way, in the oil patch, where you can buy homes for under $100,000, I would assume, in the fullness of time, that the prices are going to come back.

So, then will we be saying, if you're going to buy a house for over $101,000, that you can't get FHA insurance?

LIMIT ON FHA INSURANCE

Ms. FITTS. As you know, I read—every time I open my desk Secretary's Kemp's six objectives, the most important of which is probably affordable housing.

The two most important variables in affordable housing are what downpayment you have to make and what your monthly payment is. Every time I bought a home, I looked at what are my monthly payments? What can I afford?

The Secretary is firmly committed to removing any obstacle to affordable housing. In certain parts of the country, the limits on FHA are one of them. The limits have to go up; they really do if we're going to serve the American people.

I think there are a couple of questions we have to ask about how much they go up. This, more than anything, is an issue that's sensitive in high-cost areas, as you have said.

First, we have to look at the impact on the fund. As we described on Tuesday, the Secretary has set, as one of his initiatives on the FHA, the undertaking of a study to look at the impact of a variety of limit and limit policies on the status of the fund.

The other thing that we believe very strongly is that we are not here to compete with the private markets. If the private markets are dependably and regularly servicing the market, we don't think the Government should be in competition with it.

But I want to stress one thing I just said, and that is regularly and dependably servicing as opposed to coming in and going out.

What is critical in affordable housing is that the American people, particularly in middle and moderate income levels, have the ability to always have access to these markets.

Those are the two key pieces of information that we're going to be trying to define. I think it's our responsibility to make sure that you have that to make your decision when you come to markup your legislation.

But, clearly, the limits must go up.

Let me say one more thing about this. The MMI Fund depends on diversification, different kinds of diversification, geographical diversification more than anything. Right now, our geographical diversification is getting more and more and more limited because of the limits. We are putting out a bigger and bigger percent of our portfolio in oil patch States and certain areas that are in recession.

This makes the fund increasingly sensitive to a variety of inflation or recession scenarios. And it's going to be very important—not now, and I'm not trying to say this fund is in terrible danger, but over time, it's very important that we change that trend if we want this to be a thriving, self-supporting fund.

Senator D'AMATO. Your testimony and your answers to the several questions that I've posed to you, and that the chairman has posed to you, convince me more than ever that the President and Secretary Kemp made a wise decision in inducing you to come into public service.

And I'm indeed grateful for your responses, and we look forward—I know Senator Cranston and I both do—to the studies that you'll be completing on the effect on the fund if we raise the FHA limits. And the other questions that we've raised:

What is the proper level of participation given the private sector? And about the need for some regularity and dependability of service. We want to see that first time home buyers aren't taken advantage of, being faced with unnecessary or inflated costs that oftentimes take place at a closing.

The youngster shows up and the next thing you know, there are all kinds of service fees, et cetera, that are rather exorbitant. And that's part of protecting that market.

If you say the private sector participated and it is doing the job, it is really taking advantage by inflating the costs at a closing, thousands of dollars in extra fees, et cetera.

That's something I think we want to see is not the case. And it's that balancing that is necessary.

So, we certainly look forward to your report prior to going to markup so that we can attempt to strike that proper balance.

Mr. Chairman, I have no further questions.

Senator CRANSTON. Thank you, Al.

I'd like to ask a couple of questions that relate to the subject matter that you and I are concerned about.

It seems to me that one related question is whether the FHA Fund will be able to remain as sound as it must remain if FHA is repeatedly squeezed out of a market because of the rising prices? It's a rather and undependable role for FHA.

KEEPING FHA FUND SOUND

Ms. FITTS. Clearly, as I said before, it is extremely important that we have a number of different types of diversification, but geographical is one of them.

I think it is important to recognize, and this will be particularly important to recognize when the 1988 financial statements come out, that those statements reflect the condition and the performance of the fund through the end of September 1988.

A great deal has been done in the last 4 months to stem the kind of things that are causing some of these big losses. Not to say that we don't have a great deal to do.

But, the other thing is, having reviewed your legislation and I think getting a feel for some of the information that will come back with respect to the limits, I find it inconceivable that we can't put this fund back on a sound basis. But it's clear that we're going to need your help to do that, particularly in areas—in those areas.

Senator CRANSTON. Don't the limits have the effect of squeezing FHA out of some of the strongest, most stable housing markets?

Ms. FITTS. Absolutely. But I think it's very important that we recognize two things. That is, that we want to be in the weak markets. We want to be in the strong markets and we want to be in the weak markets.

The other thing that I believe is very important, as we take up the limits and we, therefore, give the private sector who is distributing so many of our products incentive to go to the strong mar-

kets, that we take steps to really ensure that we are distributing to the weaker markets that most need our help.

Again, not to be unctuous in my compliments, but the tools, like the State and local guarantees, give us the ability to make sure that, as this natural movement will give incentives to the private sectors to help the strong, that we have the tools to again help the weak. And we will balance that out, because I know that that has been a criticism of some as to why we shouldn't take up limits.

I think it's faulty, but I think it's important to recognize that need. And we've done it.

Senator CRANSTON. Isn't another way of looking at it that the individuals that FHA would be able to serve in strong markets tend to be families that are pretty stable. A lot of the people that we're concerned about are new families, having just bought their first homes a husband and wife perhaps both working. Making pretty good income. And they've accumulated enough to be able to get a loan in the private market.

Certainly, FHA is the answer to their problems. And they are better credit risks for FHA than many others and less likely to walk away.

Ms. FITTS. I agree, absolutely. And my team at FHA is tired of hearing me say that these people are essentially the credit that stands behind the U.S. Treasury.

And if we don't believe in them, that's a terrible, terrible thing to say. It would be like saying that we don't believe in the future of this country.

So I agree absolutely. So many things have been said about the downpayment, let me just touch on that.

Our preliminary numbers show that there is a correlation in more defaults with lower downpayments. And it's important to recognize when we talk about FHA downpayments that we permit more costs to be financed. So when we say there are downpayments that are 3 percent on the first $25,000 and then 5 percent thereafter, we are, in fact, being far more aggressive than it sounds because of what we permit to be included in financible costs.

But I think that should not mean that the downpayment should be one level or another. I think that it is one component of risk and policy. What you need to make sure of and we need to make sure of is that when we go forward with something, it is the sum package that makes sense. It is not one component or the other, because, again, risk is not bad. We must make sure that we have measurable and quantifiable risk that is justified by the benefits. And we must be comfortable that the total package will be self-supporting if that is what we choose.

Senator CRANSTON. So what you're indicating is that there may be some risk with the low downpayment, but those are offset by other strengths. And the people who are taking those risks are the people who most need help.

Ms. FITTS. I think what I'm trying to say is that, once we can measure what the costs will be, then a judgment needs to be made as to "do you want to take the risk here on the downpayment, or do you want to take the risk here? "We have to determine that we can afford some total risk. And it's a policy judgment at that time that needs to be made.

Senator CRANSTON. Are you able to express a personal view? If not, a HUD view of the way our bill is written on those two points, on the ceilings and on the downpayments?

Ms. FITTS. I really can't, and we really can't, because I think that, until we do a very comprehensive and detailed look, that to do so would be misleading and would give you bad information.

What has concerned me the most about much of the dialog that I have seen since we have gotten here is that I'm really not comfortable with our ability internally to generate very timely, good information on a pro forma basis of what different variables would do.

And I think that we all need that. So I really don't have a personal viewpoint.

Senator CRANSTON. That is obviously one area where we do need your advice before we wrap up the bill.

We'll be awaiting your thoughts on that subject.

Larry Pressler.

Senator PRESSLER. Thank you very much.

I might join in my congratulations and also congratulate you on your General Manager, Peter Monroe, whom I think is one of the most competent people that we have in the Government.

He also happens to be a classmate of mine from Harvard Law School, which has nothing to do with my feelings. [Laughter.]

But you're very lucky to have him.

I think many of my questions have been covered. I've been interested in this business of loosening credit requirements and obtaining home financing, indeed, under the Cranston-D'Amato bill.

And Pressler as a conditional cosponsor, there's a new thing. As long as the rural and small town areas are treated fairly in the bill, I remain a cosponsor.

But, in any event, I think that question has been asked. But, what study is being given to the impact of the provisions of the National Affordable Housing Act, which is my colleagues' bill that we'll have on the FHA Insurance Fund.

When do you estimate a report on the subject will be available?

And, am I correct in understanding that GAO also is considering some of these things you've covered but if you could be a little more specific.

Ms. FITTS. We delivered to Senator Cranston and Senator D'Amato and this subcommittee on Tuesday a letter which described the Secretary's initiatives to date on the fund. Also, the work we're going to be doing in the future.

It's called "FHA in the Nineties". If you don't have copies, we will submit one to you.

One of the things that is described in our initiatives is the work we want to be doing to look at the impact, well, let me go back.

First, to test the actuarial soundness of the fund today as it currently stands. But, more important, to look at the impact of a variety of policy variables, particularly terms and conditions, like limits, like premiums, like downpayments. Everything on the fund in preparation for the kind of legislation that we think we'll be needing.

We are in the process of trying to hire an independent Big Eight accounting firm to do that; it's critical for us to have that—to

advise the Secretary and to advise this body on what the policy options really are and what the impact of them are economically.

We are hoping to have that model on a computer in late fall and we are hoping that we can design it in such a way that it will give us a permanent econometric capacity at the FHA to give you timely responses on this question from now on.

FHA is one of the largest insurance operations in the world and it should have the capacity to look at these things day to day, particularly because the markets change so quickly and we are all just going to need this kind of information to make our decisions—not just this fall, but going forward.

I cannot commit to you a deadline on this since we have not yet hired the firm. We do not yet have a deadline from them. But we know that it is extremely urgent that we get this done. We will try and have it as soon as possible.

Senator PRESSLER. Thank you very much.

Senator CRANSTON. Thank you.

We're going to have a roll call in just a few moments. We'll keep going as long as we can and take a brief break.

### MALADMINISTRATION OF THE COINSURANCE PROGRAM

Another scandal, as you know, has been the maladministration of the coinsurance program. The Inspector General revealed last December that 106 or 13 percent of all section 223(f) coinsured loans were in default, for a total of $700 million.

Press reports stated that as of April, 15 percent of all such loans were in default, for a total of $857 million.

I'd like first to discuss the extent of that problem. What's the current tally, if you have it, of coinsured loans that have been in default? And what losses does the Department anticipate once these properties are disposed of?

Ms. FITTS. We do not have a good estimate of the current losses on coinsurance. Let me describe to you what some of the defaults have been on what is currently approximately an $8 billion portfolio.

We have technical defaults of approximately $938 million. To determine losses requires more information. One is, first of all, one needs to know the total profits that have been made—in other words, the premiums collected, not just the defaults, but also the recoveries.

For example, as a loan defaults and we get a property back, we sell the property and realize a recovery on the claim, we need those three figures to give you a final estimate. We are in the process of trying to estimate losses for purposes of the budget.

I do not know yet, but I suspect that if you take out of that portfolio one or two very troublesome participants, then if you really add up all the numbers, the results are not anywhere near as bad as the total would make them look.

But we do not have the final estimates.

Senator CRANSTON. The Inspector General's audit disclosed that coinsuring lenders were not adequately complying with HUD's coinsured loan underwriting and service requirements.

He found that lenders were underwriting unsound loans, over-mortgaging properties and failing to detect indications of troubled loans in a time when they are not taking adequate and timely actions to minimize mortgage defaults and coinsurance losses.

What do you think were the contributing factors to the breakdown in compliance? And is the program structurally flawed? Has the Department failed to implement and administer the program adequately?

And does FHA currently have sufficient staff to administer the program properly?

Ms. FITTS. There were two problems with the program. One, there were structural flaws in the design of the program. As you know, Secretary Kemp announced several months ago a moratorium on new entrants and a study period to look at the program. But there are structural flaws, and when that study period is over in September, we hope to announce some improvements on the basic program.

The bigger problem is, again, as I said before, that it is so important as we go forward in a more sophisticated financial world that the quality of the people that we do business with be assured.

This is where the monitoring comes in and where I think GAO's statements were so well-taken. That is, that you have to be very careful as to who is permitted into the program. And you have to make sure that if they don't perform that they are permitted out of the program very quickly.

This was not done. And I think, in our design that we propose in September, that will probably be our critical recommendation. You have to be very tough on the way in and you have to be very quick and tough on the way out.

In terms of one other thing, and I think, again, GAO touched on this, that to make those judgments of who comes in to monitor and who comes out, you need the expertise to judge these things. If you are going to delegate to various, sophisticated financial institutions the capacity to make underwriting decisions, you need within the Government the capacity to understand, to monitor, and to watch.

In enough cases, we didn't use the abilities we had. We didn't use the capacities we had. Certainly, we'll be putting more focus in terms of resources in that area to come forth with a program. But, at the core, you have to design a program so that monitoring shouldn't take an inordinate amount of time.

I can't tell you, for example, how much staff time it took to handle and manage DRG. If you were very disciplined in putting a DRG out of the program, you could use staff time to do really what they should be doing. And that's monitor the proper players in the program.

So that resource and the organization of resources would be very important. But you need far less resources if you are suspending your problem participants very quickly.

Senator CRANSTON. On May 5, the Department initiated a 120-day evaluation of the coinsurance program. During that time, HUD has increased its monitoring of existing coinsured lenders and approval of new coinsurance lenders, as I understand it.

The Department is also in the process of developing a series of program reforms, and I applaud you and Secretary Kemp for taking those actions.

What I want to ask relates to specific issues now under consideration by the Department.

What concerns and possible resolutions are being raised with respect to the existing capital and liquidity requirements?

CAPITAL AND LIQUIDITY REQUIREMENTS

Ms. FITTS. I might ask Peter Monroe here to say a few words on this. Certainly, one of the central issues we are looking at is capital because of the importance of capital, not just in the coinsurance program but all the participants to whom we delegate authority.

And I would say on the single-family side as well as the multifamily, that this is something that we will pay particular attention to.

Maybe I can just get Peter to say a few words about what we're in the process of doing on that.

Mr. MONROE. One of the things that we've done is that we have entered into a contract with a Big 8 accounting firm to evaluate our program in terms of the adequacy of capital, the adequacy of net worth of coinsurers, and also to determine what sort of loan loss reserves would be appropriate given the risk, the exposure that that coinsurer has.

It is a risk-based capital study. We expect to have the results of that study back within the next 2 weeks, in plenty of time to have some good solid recommendations on those two items before the end of the 120-day period.

Senator CRANSTON. Thank you very much.

We're going to have to leave right now. We'll be back after the vote.

[Recess.]

Senator CRANSTON. The hearing will please reconvene.

Austin, you've spoken eloquently about the complexity of the task which is carried out by FHA staff and the need for building sophistication of that staff. We have spoken of some very fine people staying there. I'm glad that's your view.

We're seeing the horrendous consequences of staff cuts made under the Reagan administration. I worry about how your efforts will be affected if budget cuts were forced by Gramm-Rudman sequestration or some other such short-sighted action. Cuts in an agency that manages risk could result in enormous costs to the taxpayer.

How will you ensure that adequate staffing levels were maintained in light of budgetary pressures?

Ms. FITTS. Mr. Chairman, the staffing issue is certainly a very important one and a very sensitive one. You should know that one of the things that we have been doing—the group in front of you and many others back at the agency—is going through the operations to determine not so much what staffing is needed but what resources are needed.

I said before how many good people there were in HUD, and I meant that. Our concern is that they have the proper resources, whether it's the proper training for programs, whether it's having a PC at their desk or not, and particularly whether they're relieved of doing things that waste an enormous amount of their time, like trying to monitor a DRG, which is a burdensome task.

So we are in the process now of trying to determine all resources necessary and I think the focus here—I know that GAO said it very well on Tuesday, when they said the problem is not quantity, the problem is quality. I don't think quality is really the best word because there are many, many quality people at HUD.

It's expertise. What expertise do they need to go forward and run a sophisticated financial operation?

And how do you get that expertise? Some of it you get by training, some you get by recruiting highly specialized people and some by contracting with outside parties to lend support, for example if it be an analysis of tax credits such as Peter mentioned on risk-based capital requirements.

So that is something that is very, very important. And I know when we get to a lot of administrative actions, and also the 1991 budget, that this is something that we will be spending a lot of time on.

As far as the question you asked on Gramm-Rudman, I don't know enough about how that process works to answer you. What I can tell you is, if you were running a very complicated financial operation where a great amount is delegated to third parties like mortgage bankers, like State and local governments who depend on timely response, you run the risk of tremendous losses if your operation should shut down, or not be able to provide the necessary service at the right moment. Some very crazy things can happen.

Now, how you protect the critical parts of that operation in a sudden cutback, I don't know. I'm not sure whether you need special provisions. I just don't know. But I think it is an important issue.

## COINSURANCE

Senator CRANSTON. We'll have to try to figure it out.

Returning to coinsurance, last September, Ginnie Mae placed DRG into default. As you know, Ginnie Mae is now beginning to sell properties of defaulted mortgages. One sale in Houston brought about $5,000 per unit.

We're told that despite these low sale prices, properties were sold without any records of their potential or required use for low-income tenants.

What are the principal objectives that reduced price sale of property should meet?

Ms. FITTS. That's an excellent question. There are two issues I would like to discuss. The first is how these sales are being handled; and then the other issue is what restrictions we put on multifamily properties when we sell them.

Right now, the coinsuring properties from the defaults, particularly the DRG defaults, are being sold by Ginnie Mae. FHA is now

working with Ginnie Mae and providing resources to the Ginnie Mae operations to assist them in assessing individual properties and kind of maximized return on the sale.

This is very important to minimize the losses on the coinsurance program because if it's not done, if each sale is not handled with attention and care, we'll lose more on the funds.

But I think you bring up a bigger issue. And that is, as you may know, on many of our multifamily properties, the 1987 and 1988 acts required that they be sold with low income restrictions on them. It brings up a question which I think that this administration and this body will have to address, and that is the balance between our desire to provide properties to low income people and whether or not we're going to use the fund as a backdoor mechanism to do that; because for many of those properties, there are no appropriations to assure that they can survive on a low income basis.

Consequently, the only way for us to proceed in the marketplace, is to destroy their value and take huge losses on the fund.

I think all of us are going to have to ask the question: Do we want to use the fund that way? Really, do we want to fund this by incurring losses on the fund? Or do we want to do it by providing appropriations?

And I think that's a policy issue that we're going to face as we have more and more of these properties to dispose of.

Senator CRANSTON. The law governing the disposition of fully insured multifamily properties requires the units to be preserved for low-income use. Some observers have argued that this requirement should be extended to the disposition of coinsured properties.

Do you agree with that assessment? Does the Department have a legal opinion to that effect? And what are the costs and benefits related to that policy?

Ms. FITTS. I don't know the answer to the question as to what our legal opinion is.

Senator CRANSTON. Would you look into that and let us know?

Ms. FITTS. Absolutely. I can get that for you and submit it for the record.

[Information follows:]

[Chairman Cranston: The law governing the disposition of fully-insured multi-family properties requires the units to be preserved for low-income use. Some observers have argued that this requirement also be to the disposition of co-insured properties. Do you agree with that assessment? Does the Department have a legal opinion to that effect? And what are the costs and benefits related to that policy?]

Ms. Fitts:

Section 203 of the [Stewart B. McKinney Homeless Assistance Act of 1988] provides that FHA-owned properties be preserved for low- and moderate-income use. To date, FHA has not experienced a case where it became owner of a defaulted co-insured property. Rather, the typical process is that the co-insuring lender forecloses on the property and sells it to cover its interests. FHA never is called on to take possession.

A slightly different case occurs when the project defaults and the co-insuring lender defaults. If GNMA has provided the funding - and in the majority of cases it has - it will take over servicing of the co-insuring lender's portfolio. GNMA effectively has become the co-insuring lender and may elect to sell the property to cover its interests. GNMA may, however, elect to assign the mortgage to FHA. In this case, the loan becomes fully insured by FHA and the provisions of section 203 would apply.

Because FHA has never been assigned a co-insured loan, it has not requested a legal opinion regarding the disposition of co-insured loans. Although FHA has not to date researched the costs or benefits of any policy covering the co-insured

portfolio, we have begun doing so and will report our findings when available.

I would like to point out that section 203 has some very serious implications for the health of FHA's financial state. Without the project-based Section 8 funding necessary to place subsidies on FHA-owned properties, FHA is unable to sell its inventory because of the income restrictions. In essence, the FHA General Insurance Fund is being used to provide direct housing subsidies. This will be enormously costly: our preliminary internal estimates are that preserving just our current inventory ~~will~~ cost over [$1 billion].

FHA's insurance funds are thus being used as a source of money for subsidies. This threatens the whole foundation of an insurance system and in the long run will lead to less housing.

Furthermore, the preservation provision spends the taxpayers money in precisely the wrong places. A project usually goes into foreclosure because it has high vacancies and soft markets. Areas where this occurs (eg., Houston) are not the areas with shortages of affordable housing. We would urge that legislation be developed which protects the insurance funds for what they were designed for, and which targets our preservation resources to areas that need it.

Ms. FITTS. We have been functioning on the basis that if a property is held by Ginnie Mae, it is not subject to those low income restrictions. There is a greater issue though, and that is that if we do need to take those and many other properties' low income where we will get the financial resources to do that.

Right now, we have many, many properties that really ought to be foreclosed on. We do not have the financial resources or the section 8 money to take them low income. And, frankly, they are sitting there wasting away and it's not benefiting low income people—and it's certainly not benefiting the fund. The fund is taking bad losses and that's a problem.

That is a balancing decision that we and this subcommittee are going to have to face in the coming years.

STAFF REDUCTIONS

Senator CRANSTON. There's another aspect of staffing I want to get into. During the past 8 years, there have been significant staff reductions in the central, regional and field offices. These staff reductions have contributed to the failure of the Department to effectively manage and monitor multifamily developments.

A management analyst of the Massachusetts Housing Finance Agency carries a caseload, for example, of 18–20 projects. Their counterpart in the HUD field office carries a caseload of 60 projects as a result of severe staff reductions.

Do you believe the Department currently has sufficient numbers of adequately trained staff to carry out management and monitoring responsibilities? And is the Department considering a request for an increase in such staff positions?

Ms. FITTS. As I said before, one of the most important issues in front of us is personnel support and personnel training. I don't know how to answer that question specifically until we have the results of our internal studies.

But, certainly, those results are going to be a critical element in our work within the administration on the 1991 budget. I think it's very important as we do that to understand a couple of items.

One is that many of the problems that the personnel and the staff have had at the agency do not relate to the quantity of staff they have, but it relates to the scope of work that they've been given to do, the organization of it, certainly the technological support they've been given.

I know, within the FHA, we have many, many people who I think, if we provide them quickly with PC's, they will be much more productive. We can do that. We have the capacity now to do that. That's simply an administrative procedure.

If they get the support—I know you asked an excellent question on Tuesday about the musical chairs. If they have the support of the leadership to do things, they can be much more productive.

So I think it's very important as we ask these questions that we think a lot about what we can do to make the current employees much more productive.

Let me just give a more meaningful example of that. I know one of the things we're all aware of is the Secretary's action or moratorium on retirement service centers—and this is a very good exam-

ple. Retirement service centers are very complicated, very novel kinds of project financing.

They require enormous specialization to look into. The system by which we were financing retirement service centers literally required almost every field officer in the country to process these things.

If we had limited and permitted just a few offices to specialize and provide it for a critical mass of people, I think you would have had much finer underwriting capacity.

That's another example of where we don't need more staff. We don't need different kinds of people. What we simply need to do is to organize the process so it recognizes the specialization required in dealing with complicated financial issues. It's those kinds of things that we're going to have to figure out.

It makes no sense for 80 field offices to all be doing a very complicated program, which is not a high-volume program. So it's those kinds of issues that we have to think about.

Senator CRANSTON. If you'll hold for a minute, I've got to take a phone call. I'll be right back.

[Recess.]

Senator CRANSTON. About 2 weeks ago, we held a hearing on the problem of drugs in publicly assisted housing. The witnesses unanimously agreed that in many cities, HUD itself was a major problem in relationship to drugs. The properties that were either owned or possessed by the Department were frequently mismanaged and subject to unimpeded deterioration. Vacancies were left unfilled for months, allowing drug traffickers to set up shop and take control of multifamily properties.

The previous administration's response was simply to ignore statutory directives and let the problem fester.

So, what action does the Department intend to implement to reverse the trend?

PROPERTY MANAGEMENT

What role should the appropriate FHA fund play in assuring that properties owned, possessed or held by the Department are adequately managed and maintained?

Ms. FITTS. That's a very good question.

We have found since we've been at HUD that we have a number of instances of very poor property management, not only by owners of properties that we have funded or insured, but also managers who, either in their capacity as owners or in their capacity as managers, are not doing what ought to be done. Not only failing to do what the law or regulations require be done, but also which we have given them the financial capacity to do.

I know the Secretary has certainly made a number of trips and announcements and has said, "This will no longer be tolerated." There are many things that need to be done and that we have just done.

One of them is to look at the holdings of many of the major owners that we have and to investigate their compliance and to take steps. And that is being done.

The other is that we have a problem in the funding of buildings which are not kept up. Requests are coming in again and again for funding, and what we're doing is taking a very hard look at the applicant's performance as they come in for funding, and we are making it clear that funding will not be forthcoming, or certainly will not be forthcoming at higher levels, unless their performance is cleaned up.

In some instances, we have initiated administrative procedures to prevent them in certain regions from participating in their own programs through what is called a 2530 action. And we have made it clear that we're going to be very aggressive on those kinds of administrative actions.

Finally, we've looked at—and this has been done in a wide range of our programs—the impact of tax benefits on their participation in programs and their holdings to make sure that they are not involving themselves solely for the purpose of getting tax benefits. They are involving themselves to properly run and manage these properties.

So, we've done many, many things. But many more remain to be done. You mentioned earlier monitoring, there has to be monitoring of these projects, and it is certainly a serious problem. It is nationwide. And it's going to take us many years to make sure that this doesn't continue.

Senator CRANSTON. I am glad you are going to be devoting your attention to that.

Section 184 of the Housing and Community Development Act of 1987 established a demonstration program requiring HUD to dispose of distressed multifamily properties through partnerships with State housing finance agencies.

To my knowledge, this program has yet to be implemented, 1½ years after the act was signed by the President in 1987. Nothing has happened, even though a number of State housing finance agencies have expressed serious interest in participating in the demonstration project.

So do you know what's holding up the implementation of the program? And can you provide the subcommittee with a timetable for the record, if not now, for implementation so we can be sure that the program will proceed on an expeditious basis?

Ms. FITTS. Mr. Chairman, I do not know the answer to that question, and I will get it and submit it for the record.

[Information follows:]

[Chairman Cranston: Section 184 of the Housing and Community Development Act of 1987 established a demonstration program requiring HUD to dispose of multi-family properties through partnerships with state housing finance agencies. To my knowledge, this program has yet to be implemented, a year and a half after the Act was signed by the President in 1987. Nothing has happened, even though a number of state housing finance agencies have expressed serious interest in participating in the demonstration project. So do you know what's holding up the implementation of the program? And can you provide the Subcommittee with a timetable for the record, if not now, for implementation so we can be sure that the program will proceed on an expeditious basis?]

Ms. Fitts: HUD initiated the demonstration of Section 184 in [May, 1988]. HUD mailed proposals to 57 state housing finance and related agencies inviting them to participate in exploring possible sales. Only 3 responses were received: Massachusetts, [California], and Ohio. The state agencies we did talk to were interested in terms which did not, in FHA's view at the time, result in true partnerships but left FHA with inordinate risk and losses.

[Mr. Chairman, I believe that FHA should be making a strong effort to work in partnership with state and local housing agencies. I have asked my staff to propose a program that will work to the benefit of both federal and local participants. I would be happy to share with you and the Subcommittee staff the results of this second look at the demonstration program.]

Ms. FITTS. One thing I do want to say is that we, in all of the Secretary's statements and many of his initiatives, see that partnerships with the State and local agencies are critical.

Again, that's one of the things we like so much about the State and local guarantees that are envisioned in your legislation. In fact, the Secretary just last week met with many of the heads of the State HFA's to discuss this, as well as many other issues.

This is a very important kind of initiative, and I will get the answer to you and submit it for the record.

Senator CRANSTON. In many areas of the country, thrift institutions are becoming less involved in FHA activities. Thrifts are contending that the decline in FHA participation is due to too much paperwork.

I fear the long-term soundness of FHA can suffer if the more sophisticated and more responsible lenders decide not to participate in this program.

DECLINING PARTICIPATION BY THRIFTS

What do you think has caused the decline of thrifts' participation, and what do you think can be done to ensure that the strongest lenders stay involved or get reinvolved?

Ms. FITTS. Again, that's an excellent question.

One of the things that has most concerned us since we've been at the agency is that there has been a great deal of talk about us participating with what are not the most desirable kind of participants in our programs.

I think one of the key ways you change that is you make it highly desirable to be a participant in one of our programs.

The strong financial institutions are the ones that we want to do business with at FHA. There are several things that are very important, and I refer again to the Secretary's initiative delivered to you on Tuesday morning.

First of all, it is extremely important in this age of computer technology that we be able to interact with them on a technologically sophisticated basis. The types of innovations in processing and technology in the backup of financial operation both in the private sector side and on the Government side permit much lower transaction costs, permits much better communication, expedited treatment. And those are critical if we're going to attract and maintain in partnership some of the more sophisticated participants—not just financial institutions, but State and local government partners as well.

So, that—computer technology, technological modernization—is critical. That's No. 1.

The other thing gets me back to financial products; these are very important. We've talked about the State and local governments, that our products be compatible with the way the capital markets are going and service the financial institutions that need them.

We've talked a little bit about pools of insurance. We're more and more going to need to be able to do pool insurance at FHA if we're going to stay current with fast-moving financial institutions doing large volumes on the market.

For example, we have an adjustable rate mortgage, but we don't do a very high volume because of the way it's structured.

Another thing your legislation envisions is more flexibility in tools like that to create products.

So I think it goes back to both technological modernization and products that really work and that these financial institutions can work with in a timely manner.

Senator CRANSTON. I'd like to ask if you can explain Secretary Kemp's FHA reforms. If you can give us a reason for the proposals in as much detail as is now ready to be revealed?

You've already discussed the need for independent financial auditing, so let's pick up each of the other proposals in turn.

First, what about provisions dealing with the revenue recognition formula? What are the details and the reason for those provisions?

SUGGESTED FHA REFORMS

Ms. FITTS. I really should supply you with more information on this for the record.

Senator CRANSTON. Fine.

[Information follows:]

[Chairman Cranston: I'd like to ask if you can explain the suggested FHA reforms of Secretary Kemp included in his FHA for the 90s. . . . First, what about provisions to the revenue recognition formula? What are the details and the reason for that?]

Ms. Fitts: On of the most important purposes of a financial statement is to accurately tell managers what is happening and suggest where attention should be placed. As I mentioned earlier, FHA needs to measure its insurance operations on an accrual as well as cash basis.

For an insurance company to accurately measure its earnings, its accounting procedures must recognize losses as soon as they occur, and recognize revenues as soon as the risk is past. The actuaries and accountants thus plot a "loss recognition curve" and a "revenue recognition curve" which match revenues with expenditures (see figure 1).

When a policy is written, the entire 3.8% premium is placed in a reserve account. (The MMI Fund currently has over $9 billion in its reserve). Each subsequent year as losses are experienced, a portion of the up-front premium is paid out of the reserve to the claiment, and a portion is realized as earnings.

If the curves are not accurate, the wrong among will be released from the reserve account. The problem at FHA is that although the loss curve is updated annually, the revenue curve has not been revised since 1984. As you can see in figure 1, the curves no longer match. It thus may be that we are

significantly under-reporting income. Some outside estimates range up to $200 million a year.

While innaccurate financials are a concern to us, we are even more concerned about real dollars being lost. And this may be happening because the revenue recognition curve is used as the basis for determining the size of our premium refunds. When a homeowner refinances or sells his house, he is entitled to a refund of the unearned [to FHA] portion of his premium payment. If we have under-estimated our earnings, we will be over-paying our premium refunds. By a simple change in its the formula, FHA's mutual fund could potentially save millions of dollars.

Ms. FITTS. In any given year, we refund a portion of the premium to policy holders who are refinancing or otherwise terminating their policy early. Estimates are made of what these refunds should be and we have been slow in updating our formulas to determine what really the proper amount to be paid is.

Currently, we estimate that we may be overpaying premium refunds. It's important that that formula is updated regularly to prevent this. It has not been, and so we intend to do that as soon as possible.

Senator CRANSTON. What should be done to comply with the Financial Managers Integrity Act?

Ms. FITTS. Again, I should submit that for the record.

[Information follows:]

[Chairman Cranston: What should be done to comply with the Federal Managers Financial Integrity Act?]

Ms. Fitts: The Federal Managers Financial Integrity Act ("FMFIA") requires that FHA officials provide reasonable assurance that funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation and that audit findings are promptly resolved.

Mr. Chairman, given the ongoing revelations of problems at HUD, we are naturally concerned that our compliance be taken very seriously. By including this provision, Secretary Kemp is making it clear that the fiduciary responsibilities of HUD's managers will be a priority from the very highest levels.

He has asked the General Counsel of HUD, Mr. Frank Keating, and myself to personally review the requirements of the Act and report on measures necessary to ensure compliance. This will be an internal process, but the results of our study will be evident throughout our management of FHA.

Ms. FITTS. The reason we intend to do that is to make sure we know all the things we ought to be doing to comply, and that we are in compliance. But the key thing is to make sure that we define and identify all the financial vulnerabilities in the organization and have the proper system controls.

Senator CRANSTON. The plan also calls for an overhaul of the actuarial analysis of the FHA funds. What are the problems there? What's being proposed and what are the problems that make it necessary for FHA to hire additional actuaries?

THE NEED FOR ADDITIONAL ACTUARIES

Ms. FITTS. I mentioned earlier that we were concerned that our participation in a limited number of markets over time was making the fund more and more sensitive to a variety of inflationary and recession scenarios. So it's critical to take a look at the current fund, particularly because a larger, meaningful part of it really reflects recent policies issued, particularly in those soft markets.

So it's important to take a look at where the fund is now. But more important, as I said earlier, is that we need the capacity to very quickly provide a wide body of people with information as to what the impact would be on an ongoing basis of doing many, many things for the fund—the different programs, the different terms and conditions on our basic policies.

To advise you, when legislation is going to come to markup, what the impact of different downpayments would be.

So it is extremely important that we have that internal capacity. And, frankly, I think it's a sign of what has gone on at HUD that we don't have one that is as comprehensive as we'd like.

To give you an example of that: as I said before, FHA is one of the largest insurance operations in the world. We have one certified actuary.

Now, I can't say enough nice things about him, but one actuary is not enough. And I think that not only do we need this capacity to make his life much easier, but that with proper technological support, he can do a lot more today. But I think we need to get some people behind him with whom he can trade some ideas.

But I don't think that requires, again, enormous staffing requirements or anything that's going to change the budget. But I think we need a few more actuaries.

Senator CRANSTON. The principal answer to the question—what are the problems that make it necessary for FHA to hire additional actuaries—is that you have one actuary. [Laughter.]

What's involved in the recommendation for improvements that could increase the distribution and marketability of FHA programs?

Ms. FITTS. Could you repeat that again?

Senator CRANSTON. What's involved in the recommendation for improvements that could, quote, "increase the distribution and marketability of FHA programs"?

Ms. FITTS. Two things, both of which I've spoken about. Right now, let's take the MMI Fund. The way we're distributing our products, 93 percent of our volume goes through mortgage bankers.

It's essentially a private sector operation. They do a good job, but they are not structured, designed and organized to target certain markets that we would like to get to, particularly inner-city markets, more risky markets. To do that, you need particular kinds of programs. To go back again, we could use flexible guarantees that can be done in combination with State and local governments, that a wide variety of agents could help us distribute, would give us the capacity to target those markets.

There is an example of what we need just for two reasons. One is to stay current, but another is to target markets. And that is the ability to issue insurance not on an individual mortgage by mortgage basis, but in a pooled form. If we at FHA have the ability to insure pools of mortgages, it would give us the ability with large financial institutions—all financial institutions—to target particular markets. To give you a little bit of an example:

If a large financial institution wanted under CRA to target inner-city areas, we could work with them to do pools. It would be much lower transaction cost, it would be faster, it would be quicker.

These are things that would take a great deal of time to design, but they would give us that ability in a very productive way to reach those places that we want to reach—not just depend on where our current agents feel like going.

Senator CRANSTON. What's being proposed to redirect accounting systems so that they are accountable to senior program leadership and that FHA managers are accountable for programs and timely and accurate financial reporting?

Ms. FITTS. Right now, we are beginning to make a study. In the initiatives letter, we discuss the fact that the Secretary has established an FHA Task Force, which is comprised of FHA and HUD officials.

One of the things we have to look at is exactly what are the systems in place to generate accounting, financial and cash management systems for the insurance operations.

Are they sufficient? And, how should they best be organized so that program managers are held accountable, that have timely information?

That is going to take a fair amount of detailed research and until that's done, we don't know the answer. But, clearly, it does not work the way it is done now.

Senator CRANSTON. How would an FHA review board function and what would be the benefits?

### FHA REVIEW BOARD

Ms. FITTS. With an FHA review board, the thinking is to bring together a wide variety of people who have expertise in housing and in this type of financial operation, who could not only advise but serve as sort of an outside look.

Again, I said before regarding the advantage of having proper financial disclosure, I really believe if such disclosure had been available over the last 4 years, and that it had been reported to a board of a wide variety of both private and public parties, who had some sort of responsibility to make sure that we were doing what

our social purpose was, we would have had a check and a balance. But it's also an advisory function that could be very useful to us.

Finally, as we've spoken, there is the need to stay current, to have more flexible financial tools. Those financial tools, however, are more powerful and require more monitoring in institutions, both in government and the private sector, like FHA.

New kinds of programs, for example something like coinsurance, are subject to the approval of a group of third parties. It's something that came to a credit review committee; that kind of independent, hard test can really be particularly useful as we start to deal with the tools that we're going to have to if FHA is going to stay current.

Senator CRANSTON. Finally, on the matter of the initiatives, would you please discuss briefly the proposed reforms of FHA's procedures for monitoring lenders?

Ms. FITTS. That's a tough question because, in every area, it's different. On the single-family side, we have many procedures in place. For example, 90 plus percent of our mortgages is distributed by mortgage bankers. We do a technical review of all insurance policies before they're issued. And we audit approximately 20 percent to make sure that these things are being done.

There are other things that need to be done. I said before that we're looking at the capital requirements that Peter spoke to you about on the multifamily side.

We need to do the same on the single-family side. We need to look at the capital requirements of the participants.

On multifamily, we're redesigning the coinsurance program, we're looking during the study period at designing and monitoring procedures with information and disclosure requirements on all the participants in the coinsurance program.

And, hopefully, we'll have those recommendations and plan to have those recommendations for you in September.

But, program by program, it's going to be different. Not only will it be looked at, but what will also be looked at is:

What expertise do we need both in-house and out of house to do that monitoring? Because it's really an expertise issue.

Senator CRANSTON. On borrower fees, some have argued that the 3.8 percent fixed borrower fee should be changed. Congress enacted that provision to head off hostile proposals that were being proposed by the Reagan administration.

Perhaps any statutory definition is more rigid than is appropriate. Some contend that high-risk and low-risk borrowers shouldn't pay the same percentage fee. Others have charged that FHA was intended to help moderate and middle income home buyers and should not charge fees to these buyers who simply can't afford it.

What are your thoughts on deregulating the borrower fee? How can we assure that any deregulation will not be misused and reduce the usefulness of FHA around the country?

Ms. FITTS. Obviously, in connection with the actuarial study, one of the things we're going to be looking at is the premium. In concept, deregulation of the fee is I think a good idea in the sense that as markets and conditions change, we do not want to be in a situation where it is extremely difficult to get what is an appropriate change on an important term for the insurance.

So, to the extent that something in statute requires enormous work to get changed, it can be complicated.

In philosophy, we would be very uncomfortable with the thought that the fee should automatically reflect, in the MMI fund, the risk. I think the last thing that is in keeping with the Secretary's objectives is to have higher premiums in the inner-city than in the suburbs.

There is a question in terms of the risk of a particular financial tool as to whether or not we would want a higher premium. For example, with adjustable rate mortgage insurance, it might be very appropriate to have a different fee than one might have on fixed rate insurance.

But that would not in any sense be discriminating against a different income group. Quite the opposite. So I think there are times when a different premium is appropriate, but certainly it is very, very important that we not make it more expensive for certain groups. We're here to make it less expensive for people to get their first home—not more.

Senator CRANSTON. With many reforms in FHA, we have to be mindful of the need to ensure that FHA be responsible in continuing as a present actor in housing.

How do you propose that we solidify the MMI Fund, yet remain true to a commitment of responsible lending in central cities and other marginal neighborhoods?

Ms. FITTS. One thing I just have to say. Everybody keeps saying: Isn't lending in the inner-city risky? I say, compared to what we've been doing for the last four years, it's not risky at all.

I grew up in the inner-city and for most of the people I grew up with all they wanted to do was get a job and own a home. And they were, I think, some of the best credit risks that I've ever seen in my life.

So I think that, properly designed, a program in the inner-city need not be more vulnerable than a program with a higher income group. But we've got to get away from the idea that these are bad risks.

I think that DRG was a bad risk. I think that many of the people in the inner-city are some of the best risks in America.

Let me just say that. What is very important is that when we assess the soundness of the fund—the MMI Fund—we assess the overall soundness.

And what I happen to believe and I'm hoping for, and I think Secretary Kemp would agree, is that when we come back with a package of terms and conditions that include working in the inner-city, that we're going to have something that's going to be very sound on a forward basis.

I said earlier that I think it's important that we not start thinking that losses and risks are bad. I think what we have to do is we have to take losses for the right reasons and risks for the right reasons.

Of course, I'm prejudiced: I think a lot of people in the inner-city are some of the best risks we could take.

Senator CRANSTON. Are there any other issues that we should discuss? Any questions you thought I'd ask that I didn't, that I should? [Laughter.]

Anything you'd like to volunteer?

Ms. FITTS. Just if I might make one comment, I think we have an enormous job ahead of us and I said earlier we're going to need your help on a lot of it.

But I think that not just what has been listed by the Secretary in his initiative for FHA, but much of what he's done since he got to HUD in a very short period of time, have been some extraordinary and, in some cases, some very difficult steps to make sure that what losses we're taking get slowed down and stopped as quickly as possible. Some of those decisions were very, very hard and some of them were very unpopular.

So I think there is a great deal to be done, but a great deal has already been done. It's been started.

The other thing though, is that we don't know the answer to many of these questions. There is a wide team of us that have been sent through the operations to go through them with a fine-tooth comb. And if we don't yet know the answers, we certainly have to at least find all of the problems and the priorities and the scope necessary to solve them.

So there's a great deal to be done and we're going to have some losses here, but I think that this Fund has a great future in front of it.

So I thank you.

Senator CRANSTON. We thank you. I do want to say you've displayed your enormous grasp of the issues you're going to be facing, and you're certainly well prepared to face them.

And we look forward to working with you on them.

I thank you for your candor, too.

And I want to assure you that I and other members of the Subcommittee will give you every support in sweeping and effective reforms that are going to be needed to make FHA a strong and effective agency for the next decade and beyond. And HUD as well.

I want to work with you, most of all, immediately on legislative initiatives that will further our common objectives. Follow-up hearings have been scheduled for September 7 and 8, when the subcommittee will review the GAO/Price-Waterhouse financial analysis.

We hope that you can be back to shed light on that at that time.

Thank you very much.

We stand adjourned.

[Whereupon, at 12:15 p.m., the subcommittee adjourned.]

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